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Supreme Court, U.S.
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In the Supreme Court of the United States

OCTOBER TERM, 1992

CHARLES A. DODGE AND
CHRISTINE Y. ROBERTS
PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE,
RESPONDENT

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

JOINT PETITION FOR WRIT OF CERTIORARI

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QUESTIONS PRESENTED

1. Have this Court's previously mandated procedural guidelines for the use and application of the burden of proof and presumption of correctness standards in Tax Court controversies been so abused by the IRS, and misapplied by the inferior federal courts, in this case, that this Court should use this case as a vehicle for further defining the IRS's proper use of the bank deposits method of determining a taxpayer's gross income, especially where the IRS's arbitrary actions have resulted in a "naked assessment" against Petitioner Roberts?

2. In a case of first impression in the interpretation of the federal tax law, did the lower courts err in partially upholding the IRS's denial of Petitioner Dodge's claim to the exclusionary tax benefits provided by Congress for the recipients of HIP insurance benefits, under 26 U.S.C. § 104(a)(3), where there is no sharply defined public policy that is being served by denying the taxpayer such benefits, and the burden of proof was erroneously placed upon Petitioner Dodge on this issue (even though the IRS's "litigating position" on this HIP benefit issue was a *new* issue, raised by the IRS only shortly before trial in the Tax Court)?

3. Though the circuit court found that the Petitioners had partially met the burden of proof placed upon them in this bank deposits reconstruction case, and therefore that court overturned several key factual findings of the Tax Court, as being clearly erroneous; did the circuit court err in failing to hold that the burden of proof shifted to the IRS to offer evidence of likely taxable sources for the remaining disputed deposits, when the Petitioners had identified nearly 90% of the deposits, the vast majority came from nontaxable sources, and the auditing revenue agent testified that he knew of only one taxable source for a small amount of the questioned deposits?

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v.

COMMISSIONER OF INTERNAL REVENUE,
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JOINT PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

Charles A. Dodge and Christine Y. Roberts jointly and respectfully petition this Court to issue a Writ of Certiorari to review the judgment entered by the United States Court of Appeals for the Eighth Circuit in this case on December 9, 1992.

OPINIONS

The Opinion of the United States Court of Appeals for the Eighth Circuit (App. A, *infra*, 1a) is reported at 981 F.2d 350. The Opinion of the United States Tax Court (App. B, *infra*, 14a) is reported at 96 T.C. 172. The Order of the United States Court of Appeals for the Eighth Circuit denying the Petition for Rehearing is unreported (App. C., *infra*, 32a).

JURISDICTION

The judgment of the United States Court of Appeals for the Eighth Circuit (App. A, *infra*, 1a) was rendered on December 9, 1992, and a timely Petition for Rehearing was filed by the Petitioners. Such Petition for Rehearing was denied by the Court of Appeals on January 20, 1993 (App. C, *infra*, 32a). The jurisdiction of this Court is invoked under the provisions of 28 U.S.C. § 1254(1).

STATUTORY PROVISIONS AND PROCEDURAL RULES INVOLVED

Statutes:

(26 U.S.C.)

Section 61. Gross Income Defined.

(a) *General Definition*. Except as otherwise provided in this subtitle, gross income means all income from whatever source derived....

* * *

(b) *Cross-References*.... For items specifically excluded from gross income, see part III (Sec. 101 and following).

Section 104. Compensation for Injuries or Sickness.

(a) *In General*. Except in the case of amounts attributable to (and not in excess of) deductions allowed under Section 213 (relating to medical, etc., expenses) for any prior taxable year, gross income does not include --

* * *

(3) Amounts received through accident or health insurance for personal injuries or sickness (other than amounts received by an employee, to the extent such amounts: (A) are attributable to contributions of the employer which were not includable in the gross income of the employee, or (B) are paid by the employer);

Tax Court Rules:

Rule 142. Burden of Proof.

(a) *General.* The burden of proof shall be upon the Petitioner, except as otherwise provided by statute or determined by the Court; except that, in respect of any new matter, increases in deficiency, and affirmative defenses, pleaded in his answer, it shall be upon the Respondent....

STATEMENT OF THE CASE

This case involves an appeal by the Petitioners to the Tax Court from the IRS's reconstruction or determination of their respective gross incomes for a four-year period (1981-1984) utilizing the bank deposits (indirect) method of proof. The IRS also belatedly asserted a *new* issue concerning the treatment of hospital indemnity insurance (HIP) policy proceeds received by Mr. Dodge, which "litigating position" presents a case of first impression in the federal courts' interpretation of 26 U.S.C. § 104(a)(3). The Tax Court and the Eighth Circuit rejected the Petitioners' positions on the application of: (1) the burden of proof, (2) presumption of correctness, and (3) naked assessment standards applicable to IRS determinations; though the IRS conceded, or the Petitioners proved, to the satisfaction of these courts, that a large number of the questioned bank deposits came from nontaxable sources. The Eighth Circuit also found that a number of the Tax Court's factual findings were clearly erroneous, and reversed those factual findings. However, the Eighth Circuit held that the Petitioners failed to carry their burden of proof regarding the HIP benefits issue, as well as to the nontaxable sources of other questioned deposits.

Though the Petitioners have attempted to meet the spirit and the letter of the requirement of Rule 14.1(g) of the Supreme Court Rules that the statement of material facts be *concise*; because of the way the IRS originated these assessments; because the evidentiary record in this case is so voluminous, and the burden of proof and naked assessment issues raised by the Petitioners are necessarily tied to these voluminous facts; the statement of the

material facts contained herein will have to be somewhat longer than usual, simply to provide the members of this Court with the necessary factual background to enable them to adequately analyze the burden of proof, presumption of correctness, naked assessment, and statutory interpretation issues that are presented here by these Petitioners.

a. Generally. Petitioners are residents of Mountain Home, Arkansas. Charles A. Dodge is approximately 62 years of age, and Christine Y. Roberts is now approximately 71 years of age. These taxpayers are not married, though they have lived together since approximately 1980. In the summer of 1981, Ms. Roberts sold her residence and rental property in Texas, and she and Mr. Dodge jointly purchased a residence and property in Mountain Home, Arkansas. The Petitioners maintained various joint and separate bank accounts in Mountain Home, Arkansas, and in Springfield, Missouri, during 1981–1984. In January of 1984, Petitioners' home burned to the ground destroying virtually all of their belongings, including most of their bank statements and other financial records. During the four years in question, neither of the Petitioners was employed. However, the Petitioners sporadically engaged in what they referred to as a "hobby" of buying and selling used vehicles, jewelry, and unmounted diamonds. The Petitioners have conceded that the "net gains" they realized from such sporadic transactions, over this four-year period, constituted gross income to them. The Tax Court's opinion determined a tax basis and sales price for such items, and allocated such "net income" between the Petitioners on a 50–50 basis. [1]

b. Christine Y. Roberts. Petitioner Roberts lived most of her adult life in the Dallas, Texas, area; she was twice married and widowed; and is retired from being the owner of a contract sewing business. During the period in question, Ms. Roberts received retirement benefits from Braniff Airways; she owned (by inheritance) some timberland in Arkansas, and several lots at an

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[1] See the charts contained in the Tax Court opinion (App. B. *infra*. 18a through 20a), and in Table 3 (App. E, *infra* 42a).

East Texas lake development; she received small oil royalties, interest payments, and her social security payments; and she realized capital gains and losses from the sale of certain properties she owned. Ms. Roberts has always filed her own Individual Federal Income Tax Returns (Forms 1040), and did so for the years 1981–1984 on a timely basis, reporting thereon all of the income that she received from her pensions, small oil royalties, interest, and the capital gains or losses from the sale of her properties. [2]

c. **Charles A. Dodge.** Petitioner Dodge has been a farmer, diesel mechanic, insurance salesman, and minister. Mr. Dodge is also widowed, and he spent most of his life, before beginning the relationship with Ms. Roberts, residing in northern Wisconsin. [3] In mid–1960's, Mr. Dodge was diagnosed

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[2] Though Ms. Roberts and Mr. Dodge filed a joint petition to the Tax Court, and a joint appeal to the Eighth Circuit, their taxable status is separate. The consequences of the IRS's utilization of the bank deposits (indirect) method of proof has very different applications to these two Petitioners, especially to Ms. Roberts; since she timely filed her tax returns; she was never personally questioned by the auditing revenue agent; and she was never given a chance to have an administrative review of the assessment the IRS proposed against her before the IRS mailed the Statutory Notice of Deficiency. Though, the decision of the Tax Court and the Eighth Circuit have reduced Ms. Roberts' computed tax liability by more than 95%, over that originally proposed by the IRS; she is still maintaining that she has suffered a great injustice because of the IRS's utilization of the bank deposit (indirect) method of proof, and the application of the presumption of correctness, burden of proof, and clearly erroneous standards, with regard to the questioned deposits Petitioners made to a separate bank account that was in her name for a short period of time in 1984. Ms. Roberts has steadfastly maintained that the IRS's actions against her in this dispute have been arbitrary and caprecious; without substantial justification, and, as the prevailing party, she is entitled to recover all of her litigating costs from the taxing agency, pursuant to the provisions of 26 U.S.C. § 7430.

[3] In the early 1970's, Petitioner Dodge became involved in counseling individuals in Iowa and Wisconsin in the preparation of W–4 Forms, so as to minimize their federal income taxes. Petitioner Dodge was charged, prosecuted, and convicted on an eight–count indictment for violating 26 U.S.C. § 7205 and 18 U.S.C. § 2. See, *United States v. Buttorff and Dodge*, 572 F.2d 619 (C.A. 8, 1978). Charles Dodge was incarcerated in a federal prison in Wisconsin for

as having spinal meningitis; he was hospitalized at a VA hospital in Dallas, Texas, and, as a result of his illness, he still suffers partial facial paralysis, partial loss of hearing, and he receives a monthly VA disability benefit. Charles A. Dodge is still formally classified as a "tax protester" on a list maintained by the IRS, though he has not been involved in, or engaged in, any "tax protester" activities since the mid–1970's. [4] During this four–year period, Charles Dodge was not employed, though he did attempt to engage in the marketing of certain specialty items. [5] During the four–year period in question, Mr. Dodge received small interest payments, his regular VA disability benefit, he secured loans from banks, and credit unions, he had loans repaid to him by others, and he received benefits from various HIP insurance policies that he had purchased personally, when he was hospitalized seven times, during this four years, because of injury or illness. Mr. Dodge also engaged in the "hobby" of buying and selling used vehicles, jewelry, and in mounted diamonds with Ms. Roberts. Mr. Dodge did not file any Federal Income Tax Returns for the years 1981–1984.

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approximately one year in 1979. Upon his release, Mr. Dodge's wife died of an unexpected brain aneurism. The IRS made an income tax assessment against Mr. Dodge for the years 1973, 1974, and 1975 (the tax years of his "tax protester" activity), and such assessment was upheld against Mr. Dodge, by default, when his attorney failed to appear at the Tax Court's hearing. *Dodge v. Commissioner*, T.C. Memo. 1983–431 (1983).

[4] The auditing revenue agent testified that, even though he did not personally question Ms. Roberts during his examination, and that he had refused or ignored her request to transfer the audit of her Federal Income Tax Returns to Charleston, West Virginia (where she was temporarily residing), he had also caused Ms. Roberts to be classified as a "tax protester" for these four years, even though she *never* engaged in any "tax protester" activities. Following the trial in the Tax Court, the IRS confirmed that it had removed Ms. Roberts' name from the taxing agency's formal "tax protester" list.

[5] The IRS stipulated in the Tax Court that the operation of this "specialty marketing venture" by Petitioner Dodge did *not* result in any net income for him during the years 1981 or 1982, the only years it was attempted.

d. IRS Audit and Assessment. In October 1985, Petitioner Dodge was first contacted by Revenue Agent James Westbrook of the IRS who inquired why Mr. Dodge had not filed Forms 1040 with the IRS for the years 1981–1984. Mr. Dodge advised the revenue agent that he had not worked at a job where he would have drawn a salary or commission for the years 1981–1984; that the vast majority of amounts deposited to his various bank accounts came from loans, loan repayments, benefits received from various HIP policies that he owned and paid for individually (which proceeds he understood were not subject to federal income tax), and other nontaxable sources. Mr. Dodge informed the revenue agent that he did not believe that he otherwise had sufficient gross income that required him to file Federal Income Tax Returns for these four years.

The revenue agent informed Mr. Dodge that his financial records for the four years would be audited, and Mr. Dodge informed the IRS agent that virtually all of his and Ms. Roberts' financial records had been destroyed in the January, 1984, fire that destroyed their home, and, therefore, he had no financial records to produce for these years. The IRS agent requested that Mr. Dodge execute a series of Forms L–266, Waivers of Notice, to allow the agent to secure copies of Mr. Dodge's records from his various banks; which waivers Mr. Dodge initially agreed to sign. However, after being advised by third parties (but not by the revenue agent) that any charges made by the banks for searching and copying these records for the IRS would be charged to Mr. Dodge; he refused to voluntarily incur such costs, and the revenue agent served administrative summons upon the banks to secure the Petitioners' records. However, even though those IRS administrative summons asked for the Petitioners' bank statements, deposits slips, and canceled checks, Revenue Agent Westbrook did *not* secure copies of the "deposited items" (i.e., the deposited checks that would have revealed the source of the deposited funds).

Revenue Agent Westbrook *never* contacted Ms. Roberts about her 1981–1984 Forms 1040, even though Ms. Roberts formally wrote to the revenue agent in April of 1986, and

requested that any audit of her Federal Income Tax Returns be transferred to West Virginia, where she had temporarily relocated.

Under normal administrative procedures, when the IRS completes an audit, it issues a "proposed" notice of deficiency (30–day letter) to the taxpayer explaining any adjustments, and offering the taxpayers an independent review of the audit by personnel of the Appellate Division of the IRS. Revenue Agent Westbrook testified that no such opportunity for an administrative review was offered to either Mr. Dodge or Ms. Roberts, at the completion of his audit, because the Petitioners were classified as "tax protesters" by the IRS. Instead, on January 17, 1987, the IRS issued separate Statutory Notices of Deficiency (90–day letters) to Charles Dodge and Christine Roberts. These Statutory Notices of Deficiencies proposed the assessment of more than $250,000 in income taxes and penalties against each of the Petitioners. These Notices reflected that Revenue Agent Westbrook had utilized the bank deposits (indirect) method of reconstructing or determining the Petitioners' gross incomes by simply adding up all deposits made to their various joint and separate bank accounts, and then inconsistently asserting that the amounts deposited to their joint bank accounts were gross income to *both* taxpayers for all four years. No real attempt was made by the IRS at the audit level to remove, from the agency's determination of gross income, deposited items that represented loan proceeds, repayments of loans, interbank transfers, HIP policy benefits, social security benefits, or other deposits that came from other nontaxable sources. [6]

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[6] It is most important to the Petitioners' burden of proof, presumption of correctness, and naked assessment arguments to note that, in the Tax Court proceeding, Revenue Agent Westbrook was called as *their* witness, and he candidly testified that the *only* "taxable sources" of deposits he found in this audit for all four years had been deposits of sales proceeds that the Petitioners received from their sporadic sales of used vehicles, jewelry, and unmounted diamonds. The revenue agent admitted that the deposits from these sources were very, very small, when compared to the total of all deposits the Petitioners made in these four years from "nontaxable sources," such as loan proceeds, loan repayments, interbank transfers, HIP policy benefits, VA disability benefits, social security benefits, etc. (Tr. 452–53; 455–56; 458–59). It must also be noted that

Upon retaining the undersigned as counsel, in 1987, and upon ascertaining that large amounts of the Petitioners' deposits came from HIP policy benefits that are statutorily excluded from the definition of gross income by the provision of 26 U.S.C. §104(a)(3), counsel for the Petitioners wrote to the IRS requesting the formal withdrawal of the Statutory Notices of Deficiency, so as to allow the parties sufficient time to review, and identify the source of the disputed bank deposits in question. By letter from the Chief, Examination Division, Little Rock District, the IRS refused to withdraw the Statutory Notices of Deficiency. Thereafter, the Tax Court Petition was filed by the Petitioners in April of 1987, and the IRS's Answer was filed in the Tax Court in June of 1987.

In the spring and summer of 1988, in accordance with Tax Court's practice, the Petitioners were afforded a post-petition administrative review of this dispute by personnel by the Appellate Division of the IRS. The Petitioners spent several hundred dollars securing *all* available copies of "deposited items" from their various banks. [7] The Petitioners and their counsel worked with the personnel of Appellate Division for several full days on these records. As a result, over 88% of the individually deposited items were identified as to their source by the Petitioners, using either

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the IRS counsel stipulated in the Tax Court proceeding that the Category 4, Previously Reported, and Category 5, Nontaxable Deposits, of the Petitioners were *not* to be included in the gross incomes of the Petitioners, thus removing more than $190,000 of deposits erroneously included in the Petitioners' gross incomes in the Statutory Notices of Deficiency. (See, App. E, *infra*, Table 1, 40a.)

[7] The Petitioners requested their banks to provide *all* of the deposited items, but some items, especially a number of large deposits at the Boatmen's Bank, Springfield, Missouri, were not available on the bank's microfilm records. These missing deposits were then grouped into Category 2, Not Identified, by the parties. However, a great number of these deposits to the Boatmen's Bank in Springfield, Missouri, were identified by the parties as coming from HIP insurance benefits; and a number of these Boatmen's deposits that were grouped in Category 2, Not Identified, appear to be similar to the other deposits by Petitioner Dodge to this account in the Springfield Bank that did come from HIP policy benefits.

the IRS's summoned bank records, or the additional bank records the Petitioners' had secured at their cost. (See, App. E., *infra*, Table 2, 41a). The Petitioners identified the source of these deposits as being from: (1) HIP policy benefits, (2) proceeds of loans, (3) transfers between banks, (4) nontaxable social security or VA disability payments, (5) proceeds from the sale of used vehicles, jewelry, and unmounted diamonds, or (6) amounts previously reported as gross income; e.g., oil royalties, capital gains, interest, etc., by Ms. Roberts on her timely filed Forms 1040. Because 12% of the total amount of these deposits could not be identified, or remained in dispute, the Petitioners and the IRS representatives could not reach a mutually agreeable basis of settlement of the IRS's proposed assessment. With the Tax Court trial then scheduled to begin on October 17, 1988, jurisdiction over the dispute was transferred in mid-August, 1988, to the District Counsel's Office of the IRS in Nashville, Tennessee.

e. *New* "Litigating Position" Asserted. On September 8, 1988, over 20 months after the two Statutory Notices of Deficiency had been issued by the IRS, and nearly 14 months after the IRS's Answer was filed in the Tax Court proceeding; the IRS's counsel wrote to the Petitioners' counsel, and, for the first time, asserted that the IRS was going to take the "litigating position" in this case that the HIP benefits received by Mr. Dodge constituted gross income to him (under the provisions of 26 U.S.C. § 61), but that Mr. Dodge would be entitled to claim deductions (presumably under the provision of 26 U.S.C. § 162) for: (1) all medical and hospital bills he incurred each year, and (2) the cost of premiums for all HIP insurance polices owned by him. This *new* "litigating position" taken by the IRS with regard to these HIP policy benefits presents "a question of first impression," with such position being taken by the IRS in this case in spite of the existence of several published rulings of longstanding by the IRS that specifically hold that any excess HIP benefits would be excludible from the

recipient's gross income, in the year of receipt, pursuant to the provision of 26 U.S.C. § 104(a)(3). [8]

The Petitioners and the IRS stipulated that Mr. Dodge owned between 30 and 60 HIP policies in each of the four years in question, which policies he had individually purchased. (See, App. E, *infra*, Table 4, 43a.) Mr. Dodge testified that he constantly bought new HIP polices, and dropped others, to try and secure better coverage. The parties stipulated that Charles Dodge had been hospitalized seven times in this four-year period (See, App. E., *infra*, Table 5, 44a) because of various injuries, or for surgery. Mr. Dodge and one of his physicians, Dr. Schroeder, testified as to the nature and reasons for each of these hospitalizations, and the hospital records and insurance claim forms for each hospitalization were stipulated as part of the Tax Court record. Mr. Dodge specifically testified that there was never any instance where he was hospitalized that he had staged an accident, or done anything to prolong the hospital stay; and he specifically denied that he had, in any way, tried to defraud HIP insurance companies by filing false or fraudulent claims. Dr. Schroeder testified about each of Mr. Dodge's hospitalizations in which he was involved, and he vigorously denied that he had, in any way, collaborated with Mr. Dodge to place him in the hospital for unnecessary purposes. The IRS did *not* offer any testimony whatsoever to rebut the stipulated medical evidence, or the testimony of the Petitioners and Dr. Schroder regarding Mr. Dodge's injuries or illnesses that necessitated these hospitalizations.

The Petitioners also offered the testimony of Mr. Ronald Sheffield, Assistant Commissioner of the Arkansas Insurance Department, who testified that there was absolutely no limitation (by either federal or state statute or regulation) upon either: (1) the number of HIP policies, or (2) the dollar amount of HIP coverage that any one individual could purchase; that the Consumer Section

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[8] See, Treasury Relations on Income Tax § 1.104-1(d); Rev. Rul. Rev. 58-602, 1958-2, Cum. Bull. 109; and Rev. Rul. 69-154, 1969-1 Cum. Bull. 146.

of his department counseled individuals who were otherwise uninsurable (e.g., persons with AIDS, cancer, etc.) to purchase as many HIP policies as possible, so as to provide these individuals with some sort of medical insurance protection that they could not otherwise secure; that the simple application forms used by the insurance companies in marketing HIP policies were almost universally accepted when received; that there was absolutely no underwriting in 99.9% of the sales of HIP policies; and that sales' solicitation for HIP policies usually stated that the cash benefits were to be paid directly to individual policyholders, in addition to all other insurance, and that such HIP proceeds were advertised as "not being subject to federal income tax." The Assistant Commissioner also testified that many elderly people "over insure" by buying many of these HIP policies because they are fearful of being wiped out financially by ever-increasing medical costs, and their need for such medical services. Finally, the State Administrator testified that he could not state how many HIP policies a consumer should purchase, because that number depended upon the financial and health condition of each person, and that person's personal desire for coverage.

On cross examination by the IRS, the Assistant Commissioner testified that he had personally investigated a situation where an individual had bought a large number of HIP policies, and immediately began to be hospitalized for long periods of time. He indicated that insurance companies would not pay such claims if the claims were fraudulent, or comprised illegal conduct on the part of the HIP policyholder to defraud the insurer.

The IRS offered the testimony of representatives of J. C. Penney Life Insurance Company, and Mutual of Omaha Life Insurance Company, who testified that they believed that Charles Dodge was an "insurance speculator." These witnesses testified that their respective companies were aware that Mr. Dodge owned a substantial number of HIP policies; that their companies gave "special handling" and examination to each claim for benefits that had been filed by Mr. Dodge; but, that each such HIP claim filed by Mr. Dodge had been paid in full. The J. C. Penney Life official

testified that he was aware of numerous instances where policyholders had been hospitalized for long periods of time from accidents (such as head injuries), or from debilitating cancers, where the hospital bills ran several-hundred-thousand dollars, and that his company limits one HIP policyholder to no more than $250.00/day in HIP benefit coverage.

The J. C. Penney Life official testified that "insurance speculation" *could* involve criminal conduct, and that he had personally testified in 30-40 mail fraud prosecutions where the Untied States prosecuted HIP policyholders who had filed fraudulent claims for benefits through the mail; where accidents causing injuries had been deliberately staged. However, this official testified that he had never seen a surgical operation faked. He further testified that, in 1982, along with a number of other HIP insurance companies, J. C. Penney Life had referred Mr. Dodge to a postal inspector in Dallas, Texas, for investigation of possible mail and insurance fraud; but, that it appeared that this postal inspector *never* contacted Mr. Dodge, and that he made no recommendation for criminal prosecution for Mr. Dodge because of such investigation.

The IRS's "litigating position" in this case specifically does not allege that Charles Dodge committed any criminal act, or submitted any false or fraudulent claims for HIP policy benefits during this four-year period of time. Instead, the IRS's "litigating position" simply asserts that Mr. Dodge had *too much* HIP policy coverage for his anticipated needs; that he was involved in "insurance speculation;" and that the HIP policy benefits received by Mr. Dodge should *not* qualify for the exclusion from gross income provided by 26 U.S.C. § 104(a)(3), because of "public policy" reasons. See, the IRS's "litigating position," as specifically reiterated and discussed by counsel in the opening statements before the Tax Court. (App. D, *infra*, 33a).

f. Tax Court Decision. Before the Tax Court, the Petitioners and the IRS agreed to stipulate all of the questioned deposits into five general categories, for purposes of briefing and argument. (See, App. E., *infra*, Table 1, 40a.) These were

Category 1, Insurance Proceeds; Category 2, Not Identified; Category 3, Miscellaneous Identified; Category 4, Previously Reported; and Category 5, Not Taxable. The parties agreed that the deposits in Categories 4 and 5 were no longer to be considered taxable, and only the amounts in Categories 1, 2, and 3 were in dispute before the Tax Court as being from taxable or nontaxable sources.

The Petitioners maintained that the IRS had improperly utilized the bank deposits (indirect) method of proof; that the two separate assessments were "naked assessments" not entitled to the normal "presumption of correctness;" that the burden of proof shifted to the IRS to show likely taxable sources for the still disputed Categories 1, 2, and 3 deposits; and, that the burden of proof was on the IRS with regard to the *new* "litigating position" on the HIP policy benefits. The IRS maintained that it had properly utilized the bank deposit (indirect) method of proof; that the burden of proof was upon the Petitioners to prove nontaxable sources for *all* questioned deposits; and, that receipt of HIP policy benefits by Mr. Dodge in each of the four years did *not* qualify for the exclusion for gross income provided by 26 U.S.C. § 104(a)(3). [9]

Judge Swift's Opinion (App. B., *infra*, 14a), refused to place the burden of proof on the IRS with regard to any issue; he applied the normal presumption of correctness standard; and, he held that the testimony of the Petitioners and Dr. Schroeder was not credible with regard to Mr. Dodge's hospitalizations. Judge Swift held that Mr. Dodge had failed to prove that any of the HIP benefits received in these four years were eligible for the exclusion

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[9] Though the IRS asserted this unique "litigating position" in this case without citation to any authority, and, in fact, in the face of longstanding published rulings of the agency that holds exactly opposite; Mr. Dodge was further hampered in his ability to even prove the payment of HIP premiums on medical bills, because of the fire that destroyed all of his financial records in January of 1984. Thus, Petitioner Dodge was put at an extreme disadvantage, at the time of trial, in even trying to meet the requirements of the IRS's *new* "litigating position."

from gross income provided by 26 U.S.C. § 104(a)(3). Though Judge Swift did find for the Petitioners on a number of issues, [10] he determined that the Petitioners had generally failed to meet their burden of proof on the nontaxable sources of the disputed deposits. He allocated all Category 2, Not Identified, and Category 3, Miscellaneous Identified, deposits to be the gross income of Mr. Dodge, except for the disputed deposits the Petitioners made to a separate account that Ms. Roberts maintained for a short period of time, in 1984. (App. B, *infra*, 29a). A timely Joint Notice of Appeal was filed by these Petitioners to the United States Court of Appeals for the Eighth Circuit.

g. Eighth Circuit's Decision. The Eighth Circuit also refused to shift the burden of proof to the IRS, with regard to *either* of the Petitioner's separate assessments; but, the circuit court did find that certain of the Tax Court's findings of fact were clearly erroneous, and had to be reversed. These included a loan repayment, and proceeds of jewelry and vehicle sales being counted twice, and that one of Mr. Dodge's hospitalizations (where he had undergone surgery) qualified those particular HIP policy benefits for total exclusion from his gross income, because --

> even an "insurance speculator" may suffer legitimate catastrophic illnesses; when that occurs, § 104(a)(3) operates to exclude the benefits they receive due to illness or personal injury, just as it would as any other taxpayer. That the benefits may exceed the taxpayer's actual immediate medical expenses at no consequence under the plain language of the statute, so long as the illness is genuine. (App. A, *infra*, 9a).

The Petitioners filed a timely Petition for Rehearing, with suggestion for Rehearing, *en banc*, which Petition was denied, and this Petition for Certiorari was then timely filed.

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[10] Including the applicability of the statute of limitations on assessment, with regard to Petitioner Roberts, the allowance of a casualty loss, the proper amount of interest deductions, etc. and similar issues.

REASONS FOR GRANTING THE PETITION

Though the Petitioners have filed a Joint Petition for Certiorari, and there are common issues presented, they also individually present different underlying reasons as to why this Court should grant their Petition, and review the special and important issues that they are each presenting separately.

With regard to Petitioner Roberts, it is submitted that the "guilt by association" treatment given to her, originally by the IRS, then by the Tax Court, and, to some extent, by the Eighth Circuit's decision, presents important issues regarding the proper application of the burden of proof, presumption of correctness, naked assessment, and clearly erroneous standards applied by the lower courts here that are in clear conflict with this Court's prior decisions in the cases of *Helvering v. Taylor*, 291, U.S. 507 (1935), and *United States v. Janis*, 482, U.S. 433 (1976), as well as with the prior decisions of the Court of Appeals for the Fifth Circuit in *Portillo v. Commissioner*, 932 F.2d 1128 (C.A. 5, 1991), and *Armes v. Commissioner*, 448 F.2d 932 (C.A. 5, 1971). Ms. Roberts' Petition provides this Court with a vehicle to further refine and annunciate the proper application of these standards, especially with regard to the utilization of the bank deposits (indirect) method of proof, and the naked assessment exception to the normal presumption of correctness standards that are generally applicable to IRS assessments. [11]

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[11] Christine Roberts is of advanced age, limited means, and she has complied with all statutory requirements regarding the filing of Federal Income Tax Returns, and the reporting of gross income. Ms. Roberts has been treated differently (i.e., as a "tax protester") simply because of her close association with Charles Dodge. When viewed separately, the facts established in the evidentiary record in this case clearly show that the IRS, the Tax Court, and the Eighth Circuit have not properly applied the standards for utilization of the bank deposits (indirect) method of proof, the presumption of correctness, and the clearly erroneous standards established by the Eighth Circuit's own prior decisions. See, *Gleckman v. United States*, 88 F.2d 349 (C.A. 8, 1935) cert. denied, 297 U.S. 709 (1936); *Kirsch v. United States*, 174 F.2d 595 (C.A. 8, 1949); *Dillion v. United States*, 218 F.2d 97 (C.A. 8, 1955); *Campbell County State Bank, Inc. v. Commissioner*, 311 F.2d 374 (C.A. 8, 1963), and *Commissioner v. Riss*, 374 F.2d

Besides the burden of proof, presumption of correctness, and naked assessment standards that are also applicable to Petitioner Dodge's appeal, the refusal of the Tax Court and the Eighth Circuit to place the burden of proof on the IRS, with regard to the *new* issue that the IRS belatedly raised on the HIP policy proceeds, and the denial by the IRS, the Tax Court, and partially by the Eighth Circuit, of Petitioner Dodge's claim to the exclusionary tax benefit for the HIP policy proceeds he received in these four years, as specifically provided by Congress in the provisions of 26 U.S.C. § 104(a)(3), provides a "case of first impression" on this issue of interpretation of the federal tax statute. Such "litigating position" of the IRS is diametrically opposed to longstanding published administrative rulings by this federal taxing agency on this same subject; which administrative rulings have *not* been modified or withdrawn, since the IRS's "litigating position" was first announced in this case on September 8, 1988. Therefore, this Court should grant Petitioner Dodge's Petition, and rule that such HIP benefits qualify for the exclusion from gross income because there is no clear-cut "public policy" against a taxpayer's purchase of, or claim against, multiple HIP policies. Since the IRS has specifically estopped itself from claiming that Charles Dodge filed false or fraudulent claims with his HIP insurers, the assertion of such a *new* "litigating position" by the IRS, in this case, is in direct conflict with this Court's prior decisions in *Commissioner v. Heininger*, 320 U.S. 467 (1943); *Lilly v. Commissioner*, 343 U.S. 90 (1952); *Commissioner v. Sullivan*, 356 U.S. 27 (1958); *Tank Truck Rentals, Inc. v. Commissioner*, 356 U.S. 30 (1958); and *Hoover Motor Express Co., Inc. v. Commissioner*, 356 U.S. 30 (1958), wherein this Court held that taxpayers are not to be denied the rights and tax benefits statutorily conferred upon them by Congress, unless, as a matter of clear and sharply defined "public policy," there is a state or federal law that *clearly* identifies and defines that the claiming of these HIP benefits is against a stated "public policy."

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161 (C.A. 8, 1967). The conflict (here, with the same circuit court's prior decisions) also provides another reason for the Court to grant Ms. Roberts' Petition.

Thus, the Petitioners submit that, under the provisions of Rule 10.1(a) and (c), of this Court's Rules, there are special and important reasons presented as to why this Court should grant their Petition for Certiorari, which reasons are described below.

I. THE TAX COURT AND THE EIGHTH CIRCUIT HAVE MISAPPLIED THE PRESUMPTION OF CORRECTNESS AND BURDEN OF PROOF STANDARDS, SET BY THIS COURT'S PRIOR DECISIONS, BECAUSE THE IRS MADE "NAKED ASSESSMENTS" IN THIS CASE, BASED UPON AN IMPROPER APPLICATION OF THE BANK DEPOSITS (INDIRECT) METHOD OF PROOF.

The evidentiary record established in this case presents a classic situation where the IRS has abused its assessment authority, primarily because of its continued, but erroneous, classification of Petitioner Dodge as a "tax protester." The IRS misused the bank deposits (indirect) method of proof in arbitrarily and inconsistently determining separate gross incomes for both Petitioners. Then, relying solely upon the presumption of correctness that normally attaches to the IRS's initial determination, the IRS has proposed enormous assessments of income tax and penalties against *both* Petitioners, and has attempted to put *both* Ms. Roberts and Mr. Dodge to an impossible burden of proof. Also, the IRS failed to offer *any* proof of its own to buttress its determinations that these gross incomes of the Petitioners came from *taxable* sources. The IRS also failed to offer *any* evidence to support its assessments, or its belatedly asserted "litigating position" with regard to the HIP policy benefits. This Court ruled, nearly 60 years ago, in the case of *Helvering v. Taylor*, 293 U.S. 507 (1935), that the normal "presumption of correctness" that attaches to the IRS's initial determinations made by the IRS in a tax dispute disappears when the taxpayer offers cogent evidence to disprove the basis of the IRS's determination. Since this is a Tax Court proceeding, not a refund action in a district court proceeding, the burden of proof necessarily shifts to the IRS to offer evidence to sustain its assessment, and, if the taxing agency fails to do so (as it failed

here), then the entire assessment is to be stricken as unsustainable.

Even the "presumption of correctness" standard does *not* apply where the IRS has made a "naked assessment," i.e., one that is excessive and without rational foundation. See, *Helvering v. Taylor*, 293 U.S., at 514–517; and *United States v. Janis*, 428 U.S. 433, 441 (1976). The decisions of the Tax Court and the Eighth Circuit, in this case, are also in conflict with the decisions by the Fifth Circuit in the case of *Portillo v. Commissioner*, 932 F.2d 1128 (C.A. 5, 1991), and *Armes v. Commissioner*, 448 F.2d 932 (C.A. 5, 1971), regarding the presumption of correctness, naked assessments, and the shifting of the burden of proof standards that are applicable in factual situations, like those presented in this case, where the IRS has proposed an arbitrary and ill–founded assessment.

The evidentiary record in this case clearly establishes that, even though Revenue Agent Westbrook admittedly knew of the many nontaxable sources of the Petitioners' deposits during this four–year period, and of only one taxable source (i.e., the few deposits from the proceeds from the Petitioners' sporadic sales of used vehicles, jewelry, and uncut diamonds), the IRS's actions in simply totaling up *all* of the Petitioners' deposits; asserting huge proposed deficiencies of income tax and penalties; and, then, offering no substantive evidence in support of its determinations (but, instead, relying solely upon its "presumption of correctness"), causes the assessments proposed against *both* Petitioners in this dispute to be "excessive and without rational foundation."

Though this Court has long ago approved the IRS's use of indirect methods of reconstructing a taxpayer's gross income, when sufficient records are not available from the taxpayer, Petitioner Roberts has consistently maintained in this action that the IRS's assessment against her is clearly a "naked assessment," which is *not* entitled to the usual presumption of correctness, because there has been absolutely no showing that she had income from any taxable sources (other than those she reported on her timely–filed tax returns), *and* the IRS agent never contacted her, or questioned her about her records or the correctness of her gross income, as she

reported it on the Forms 1040 she filed. *Gleckmen v. United States*, 80 F.2d 349 (C.A. 8, 1935), *cert. denied*, 297 U.S. 709 (1936), long ago set the standards for the IRS's determination of a taxpayer's gross income, based upon the bank deposits (indirect) method of proof (80 F.2d, at 339). There, that court held:

> It may be conceded also that the bare fact, standing alone, that a man has deposited a sum of money into a bank would not prove that he owed income tax on the amount; nor would the bare fact that he received and cashed a check for a large amount, in and of itself, suffice to establish that income was due on account of it.
>
> On the other hand, if it is shown that a man has a business or calling of a lucrative nature, and is consistently, day by day and month by month, receiving monies, and depositing them to his account, and checking against them for his own uses, there is most potent testimony that he has income, and, if the amount exceeds exemptions and deductions, that the income is taxable.

Thus, for the IRS to properly use the bank deposits (indirect) method of proof, three prerequisites must be established: (1) that the taxpayer was engaged in an income-producing business or calling; (2) that the taxpayer made regular deposits of funds into bank accounts; and (3) that an adequate and full investigation of those accounts was conducted by the IRS in order to distinguish between taxable and nontaxable deposits. The evidentiary record in this case clearly establishes that the IRS's actions here violated both the first and third of these requirements, since the IRS has not established that either Ms. Roberts or Mr. Dodge was engaged in an income-producing business or calling in these four years, and the IRS totally failed to make an adequate investigation of these accounts, so as to be able to distinguish between taxable and nontaxable sources for these deposits.

The failure of the Eighth Circuit to hold, under the facts established in this case, that the IRS's use of the bank deposits (indirect) method of proof has resulted in a "naked assessment"

(especially as to Ms. Roberts) is a clearly erroneous determination that stands in direct conflict with that circuit court's own prior decision in *Kirsch v. United States*, 174 F.2d 595 (C.A. 8, 1949), and with the First Circuit's decision in *United States v. Morse*, 491 F.2d 149, 152 (C.A. 1, 1974).

Thus, under any proper application of this Court's previously determined burden of proof standards, for Tax Court cases, the Tax Court and the Eighth Circuit erroneously failed to find that the separate assessments in question, especially the one proposed against Ms. Roberts, were mere "naked assessments" that are *not* entitled to the normal presumption of correctness, as to the IRS's initial determinations. The IRS's failure to offer any cogent evidence as to taxable sources for the three categories of questioned deposits, when the burden of proof was shifted to the taxing agency, causes its assessments to fail, in their entirety. Therefore, this Court should grant this Petition for Certiorari, reverse the decision of the inferior courts, and render judgment for both of the Petitioners. See, *Helvering v. Taylor*, *supra*; *United States v. Janis*, *supra*; *Commissioner v. Riss*, 374 F.2d 161 (C.A. 8, 1967); and *Ehlers v. Vinal*, 382 F.2d 58, 65–66 (C.A. 8, 1967).

II. THE BURDEN OF PROOF ON THE IRS'S BELATEDLY ASSERTED *NEW* "LITIGATING POSITION," REGARDING THE HIP BENEFITS, WAS ERRONEOUSLY PLACED UPON PETITIONER DODGE REQUIRING HIM TO PROVE THAT HE WAS ENTITLED TO CLAIM THE BENEFIT OF THE EXCLUSION FROM GROSS INCOME PROVIDED BY 26 U.S.C. § 104(a)(3).

Through personal effort, and the expenditure of substantial sums of money, the Petitioners and their counsel, working with the IRS Appeals Officer (nearly a year after the IRS's Answer was filed in the Tax Court proceeding), were able to identify the source of over $250,000.00 of the questioned deposits in these four years

as being from HIP insurance benefits received by Mr. Dodge from HIP insurance policies that he personally had paid for during the years in question. It was *only* after this dispute was referred to the IRS's counsel for trial preparation before the Tax Court that the IRS first asserted its *new* "litigating position," i.e., those deposits identified as Category 1, Insurance Proceeds, did *not* qualify for the statutory exclusion for gross income, as provided by 26 U.S.C. § 104(a)(3), but that Petitioner Dodge was to be allowed deductions from gross income for: (1) all medical and hospital costs he actually incurred, and (2) all HIP premiums he actually paid.

Clearly, under *any* reading of the express provisions of Rule 142(a) of the Tax Court's Rules, *supra*, this belatedly asserted "litigating position" by the IRS is a *new* issue that was raised by the IRS fourteen months after its Answer was filed in the Tax Court. Therefore, the burden of proof on this *new* issue should have been placed squarely upon the IRS by the inferior courts. [12] Not only was the taxable status of the HIP benefits a *new* issue belatedly raised by the IRS, but this *new* "litigating position" asserted by the IRS against Mr. Dodge, in this case, is diametrically opposite to longstanding published rulings of the IRS, [13] which rulings expressly provide that receipt of HIP benefits, in excess of actual medically related expenditures, still qualifies for the exclusion from gross income that Congress has proved, since 1918, by this statutory provision.

In 1954, Congress amended the Internal Revenue Code to provide, in § 104(a)(3), that the excess of HIP benefits a taxpayer receives from an *employer*-provided HIP policy is *not* to be

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[12] Pursuant to the provisions of Rule 142(a) of the Tax Court, *supra*, the burden of proof should also have been placed upon the IRS to prove the taxable source of the added deposits that increased Petitioner Dodge's deficiencies for the years 1983 and 1984, over and above the deficiencies originally asserted against him in the Statutory Notice of Deficiency.

[13] See, Regulations and Income Tax, § 1.104-1(d); Rev. Rul. 58-602, 1958-2 Cum. Bull, 109, or Rev. Rul. 69-154, 1969-1 Cum. Bull 146.

excluded from the taxpayer's gross income; only the amounts of HIP benefits equal to the taxpayer's medical expenses are to be excluded. This tax treatment is *roughly* what the IRS seeks to impose on Mr. Dodge by its belatedly asserted "litigating position" in this case. However, Congress chose, in 1954, to continue the total exclusion of HIP benefits received by a taxpayer from HIP policies purchased by the taxpayer himself. Unquestionably, the record, in this case, reflects that Mr. Dodge individually bought and paid the premiums on *all* of the HIP policies in question. Thus, since Congress has, since 1918, provided for the total exclusion from a taxpayer's gross income of HIP benefits (like those in question here), Petitioner Dodge submits that, if the IRS wants to change this longstanding tax law, that Congress, not the courts, is the proper branch of government to which the taxing agency should appeal to exercise such a legislative function. [14]

The telling point against the IRS's "litigating position," under *any* burden of proof standard, is that it is ill-founded and cannot be upheld, in the face of the clear wording of § 104(a)(3), and the IRS's own published rulings on this issue. [15] As specifically stated by the IRS's counsel, before the Tax Court trial

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[14] Congress recently did amend 26 U.S.C. § 104(a), by the provision of P.L. 101-239 (1989), to provide that punitive damage awards received by taxpayers, for reasons other than physical injuries or sickness, were *not* to be covered by the exclusion from gross income set forth in § 104(a)(2). The same type of action could be taken by Congress on this subject, if Congress so decided to act.

[15] Though the "litigating position" of the IRS in this case was asserted against Charles Dodge on September 8, 1988; the IRS has not, in the last 4 1/2 years, withdrawn or modified any of its published rulings that allow the excess in HIP benefits, over actual medical expenses incurred, to qualify for the exclusion Congress provided in 26 U.S.C. § 104(a)(3). See, footnote 13, *supra*. There are no other reported cases where the IRS has asserted this same "litigating position" against any other taxpayer. Thus, Charles Dodge submits that this Court must not allow the IRS to further misuse its awesome powers against him, in applying the burden or proof and presumption of correctness standards against him on a bank deposits method of reconstructing his gross income, simply because the personnel of the taxing agency have erroneously branded him a "tax protestor" and they are still trying to exact a "pound of flesh" from him.

began (App. D, *infra*, 33a), the IRS's "litigating position" here is *not* that Mr. Dodge's HIP benefit claims were false or fraudulent (i.e., the subject of fraudulent or criminal conduct by Petitioner Dodge), only that Mr. Dodge had *too* much HIP coverage for his anticipated needs; that he was an "insurance speculator;" and, for "public policy" reasons, Mr. Dodge should *not* be entitled to claim the exclusion from gross income benefit that Congress provided in 26 U.S.C. § 104(a)(3).

This is a "subjective test" suggested by the IRS that will have to be applied on an *ad hoc*, case-by-case basis; where the auditing revenue agents may substitute their judgment for that of the taxpayer-policyholder, depending upon the facts of each situation. [16] Such a "subjective test" is unworkable, because it could "open Pandora's box," and encourage a multitude of litigation on this point. As the Assistant Arkansas Insurance Commissioner testified before the Tax Court, in some instances (e.g., AIDS), 200 HIP policies may not provide enough coverage for a taxpayer; while in other instances (e.g., a simple fall), three or four HIP policies may be more than is needed to cover the immediate medical costs. However, as noted by the Eighth Circuit in its decision (App. A, *infra*, Ftnt. 7, 10a); and, by the J. C. Penney Life official who testified at the trial, HIP policyholders --

> cannot predict when they should start carrying more HIP coverage to provide them with funds for the long, uncertain, period ahead...[and] neither can the average taxpayer predict

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[16] As the Eighth Circuit noted in its Opinion (App. A., *infra*, 10a), there is merit to the Petitioners' argument that the IRS should not be added to the proliferating ranks of nonprofessionals attempting to assert themselves into the doctor-patient relationship to define appropriate care; and, further, that the circuit court would not uphold a determination by the IRS that disagreed with the appropriateness of the medical care given, or a determination that the taxpayer was over insured. Notwithstanding this statement of principle; coupled with the fact that Mr. Dodge's HIP insurer's gave all of his claims for HIP benefits "special scrutiny;" Mr. Dodge submits that the Eighth Circuit has allowed exactly this situation to occur in this case, because of that court's erroneous application of the burden of proof and presumption of correctness standards.

when he or she will unexpectedly suffer a catastrophic health problem.

Petitioner Dodge has consistently maintained in this dispute that the *only* workable and "objective test" that can be applied by the IRS in this type of factual situation is where the HIP benefits are secured by the policyholder through false or fraudulent claims made to the insurance company. In that situation, there would be a clear and sharply defined "public policy" against allowing a taxpayer to claim these tax benefits, provided by the exclusion from gross income contained in 26 U.S.C. § 104(a)(3). In fact, since such claims would constitute criminal activity, the receipt of such HIP benefits would be taxable under 26 U.S.C. § 61, and this Court's prior decision in *James v. United States*, 366 U.S. 230 (1961). [17]

The plain and simple answer to the IRS's "litigating position" in this case is that this Court has previously and continuously refused, in every case, to allow the IRS to deny tax benefits statutorily created by Congress for taxpayers, unless there is a clear or sharply defined "public policy" reason for denying such tax benefits. See, *Commissioner v. Heininger*, 320 U.S. 467 (1943); *Lilly v. Commissioner*, 343 U.S. 90 (1952); *Commissioner v. Sullivan*, 356 U.S. 27 (1958); *Tank Truck Rentals, Inc. v. Commissioner*, 356 U.S. 30 (1958); and *Hoover Motor Express Co., Inc. v. Commissioner*, 356 U.S. 38 (1958). The same rationale must be applicable here to uphold Petitioners' position, and sustain this Court's longstanding guidelines to the IRS and the nation's taxpayers on such "public policy" issues.

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[17] Since the IRS's "litigating position" asserted in this case clearly states that the taxing agency is *not* asserting that Mr. Dodge's claims for HIP benefits were false or fraudulent, during the four years in question; only that he had *too* much HIP coverage and that he was therefore an "insurance speculator," the IRS is estopped from now claiming that Mr. Dodge's HIP insurance claims constituted criminal conduct. Accordingly, even under the IRS's "litigating position", the exclusion from gross income provided by § 104(a)(3) should be applicable here, because there is simply no "public policy" or any other restriction over how many HIP policies any one taxpayer may purchase or claim against.

This Court has long favored a liberal construction of the statutory provision in question. See, *Haynes v. United States*, 353 U.S. 81 (1957). In fact, the only other reported case, where the IRS has ever attempted to raise a "litigating position" that is even similar to the one that it has taken against Mr. Dodge in this case, was a 1947 decision of the Tax Court in the case of *Deming v. Commissioner*, 9 T. C. 383 (197). In *Deming*, the taxpayer received $7,011.60 in HIP insurance indemnity benefits during the year, and he had incurred medical expenses of only $2,117.90. [18] In *Deming*, the IRS was *not* attempting to subject the excess amounts of HIP benefits to income tax; the IRS was only attempting to limit the amount of medical expenses the taxpayer could deduct, since certain of the policies had paid indemnity benefits, and other policies had paid for specific medical reimbursements. In *Deming*, the Tax Court specifically held that the amount of HIP benefits received by the policyholder did not constitute insurance reimbursements that would otherwise limit the deduction of the taxpayer's statutorily authorized medical expenses.

To sustain his claim to the exclusion from gross income benefit provided to him by § 104(a)(3) at the trial in the Tax Court, Charles Dodge offered into evidence all of his medical and hospital records; his HIP insurance claims; his own uncontradicted testimony; and, the testimony of one of his attending physicians, to prove that he had suffered personal injury or sickness on each of the seven occasions that he was hospitalized during this four-year period of time. The IRS offered absolutely no testimony or evidence to contradict or rebut Mr. Dodge's proof on this issue. The IRS rested its case solely upon the presumption of correctness of its original determination. Mr. Dodge's proof in this

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[18] It should be noted that, due to normal inflation, the HIP policy benefits received and medical expenses described in the *Deming* case, in 1947, are probably equivalent to ten times those amounts in today's dollars. Thus, Petitioner Dodge submits that the factual situation described in the *Deming* case parallels that presented by him in this instant appeal, regarding the amounts in dispute with regard to the identified HIP insurance benefits and the related medical expenses.

case is the same proof that had been accepted by all of the HIP insurers who, though they gave "special scrutiny" to each of Mr. Dodge's claims for HIP benefits, paid *all* of these claims during the four years in question.

The tax benefit provided by this statutory exclusion was originally denied to Mr. Dodge, only because the Tax Court Judge erroneously ruled that he had the burden of proof to overcome the presumption of correctness given the IRS's initial (but arbitrary) determination, and that Mr. Dodge had failed to meet his burden, partially because he was held not to be a credible witness. The Eighth Circuit partially reversed this finding, as being clearly erroneous as to one hospitalization, [19] but, the circuit court did not overturn the Tax Court Judge's findings that denied Mr. Dodge the claimed tax benefit for six out of seven of his hospitalizations. Petitioner Dodge submits that this Court should grant his Petition and reverse the lower courts' decisions, so as to set "objective standards" for the IRS's interpretation of § 104(a)(3), and to put an end to the federal taxing agency's arbitrary treatment of him, because of his actions of long ago, as a tax protester.

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[19] The only reason that Judge Swift appears to have rejected Petitioner Dodge's un-rebutted evidence on the question of illness or injury was that the judge specifically found the testimony of the Petitioners and the physician not to be credible. Under the standard of appellate review set down by this Court in *Anderson v. City of Bessemer*, 470 U.S. 562 (1985), the Eighth Circuit, relying upon the extrinsic evidence of Mr. Dodge's injury or illness in the record, found that the Tax Court's finding of fact regarding Mr. Dodge's hospitalization that involved surgery was clearly erroneous, and reversed such finding. Notwithstanding the improper placement of the burden of proof on Petitioner Dodge by the Tax Court and the Eighth Circuit, Mr. Dodge submits that this same extrinsic evidence, regarding his other 6 hospitalizations (which evidence stands un-rebutted and which was accepted by all of the HIP insurers) should have been deemed sufficient to sustain his claim to the exclusionary tax benefit provided by § 104(a)(3), even if this Court should find that Mr. Dodge did have the burden of proof in this case.

III. THE PETITIONERS' IDENTIFICATION OF VIRTUALLY ALL OF THE DEPOSITED ITEMS AS BEING FROM NONTAXABLE SOURCES, SHIFTED THE BURDEN OF PROOF TO THE IRS TO OFFER EVIDENCE OF POSSIBLE TAXABLE SOURCES FOR THE REMAINING DISPUTED DEPOSITED ITEMS, AND THE LOWER COURTS' FAILURE TO SO SHIFT THE BURDEN TO THE IRS ON THIS QUESTION WAS CLEAR ERROR.

Simply because the IRS has continued (for more than 15 years) to formally classify Charles Dodge as a "tax protester," the IRS has, in this dispute, treated *both* Mr. Dodge and Ms. Roberts in such an arbitrary manner that it borders on denying *both* of the Petitioners their rights to due process. Though Revenue Agent Westbrook testified that he was aware that the deposited items in question generally came from nontaxable sources, such as loans, loan repayments, HIP policy benefits, interbank transfers, disability benefits, social security benefits, etc., he simply totalled up the deposits, *inconsistently* treated the totals as gross income for *both*, computed huge proposed assessments of income tax and penalties, and then attempted to put the Petitioners to a burden of proof the agency knew the Petitioners could never meet. This is especially true with regard to items where *neither* the IRS *nor* the banks have been able to secure copies of the "deposited items" (e.g., checks written to, and deposited by, the Petitioners), because the Petitioners had lost most of their financial records in the 1984 fire that totally destroyed their home. Revenue Agent Westbrook also candidly has admitted that the *only* "taxable source" of the deposits that he found (during his nearly two-year examination) was the very, very small number of deposits attributable to the Petitioners' sporadic sales of used vehicles, jewelry, and unmounted diamonds.

In light of these admitted facts, and coupled with Petitioners' ability to identify 88% of the deposited items as to source (with virtually all such deposits coming from nontaxable sources), then the Petitioners submit that, under a proper application of the burden of proof standards applicable in Tax

Court cases, that they have met their burden of proof, and that the burden of proof has been shifted to the IRS to offer evidence that proves likely taxable sources for the remaining unidentified or disputed deposited items in Categories 2 and 3. See, *Helvring v. Taylor*, *supra*, and *Armes v. Commissioner*, 448 F.2d 932 (C.A. 5, 1971).

Though the Eighth Circuit found that the Tax Court's decision was clearly erroneous under this Court's standards of review, see *Anderson v. City of Bessemer*, 470 U.S. 564 (1985), with regard to: (1) the "double inclusion" of deposits attributable to the proceeds from the sale of used vehicles, jewelry, and unmounted diamonds; (2) the failure to remove the large loan repayment by Dr. Schroeder from Petitioner Roberts' income for 1984; and (3) the erroneous failure to delete the HIP benefits attributable to Mr. Dodge's surgery; both lower courts upheld the IRS's determinations with regard to the balance of all of the Category 2, Not Identified, and Category 3, Miscellaneous Identified, items in question. The Petitioners, especially Ms. Roberts, submits that the burden of proof shifted to the IRS to offer evidence of likely taxable sources for the balance of these Category 2 and 3 items. If the burden of proof was properly placed upon the IRS, Ms. Roberts would have virtually no additional income, and she could claim the benefit of the statute of limitations against assessment for the year 1982, as she did successfully for such statute of limitations for the year 1981. [20] Since the IRS failed to offer any evidence of taxable sources for these disputed items, but, instead, the IRS merely

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[20] Petitioner Roberts points out to the Court that Judge Swift allocated *all* Category 2 and 3 deposits, except for those deposits made to the separate bank account she maintained for a few months in 1984, to Mr. Dodge. The Eighth Circuit's decision removed the majority, but not all, of these Category 2 and 3 deposits from her 1984 gross income. Since there is absolutely no evidence in the record in this case to even hint that Ms. Roberts had income from taxable sources during 1984 she submits that the lower courts' final determination of her 1984 gross income is clearly erroneous, and must be revised by this Court to keep her from being severely damaged financially because of the arbitrary action taken against her in this case by the IRS.

rested, to its detriment, upon the presumption of correctness attributed to its initial determinations, this Court should grant the Petition for Certiorari and hold that the IRS's assessments against both Petitioners must fail because they are excessive and not rationally based. See, *Helvring v. Taylor*, *supra*, and *United States v. Janis*, *supra*. [21]

CONCLUSION

For the aforementioned reasons, the Petitioners submit that the Court should grant their Joint Petition for Certiorari, answer the important questions of federal taxation presented, one of which is a question of first impression, and render judgment in their favor.

Respectfully submitted,

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For Petitioners

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[21] The Petitioners submit that the penalties proposed by the IRS are unwarranted, and, in any event, will not be applicable upon this Court's ordering the lower courts to properly impose the burden of proof upon the IRS. However, the Petitioners do preserve their right to seek, and still do seek, the award of all of their litigating costs in this case, including attorneys' fees, under the provisions of 26 U.S.C. § 7430.

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APPENDIX A

United States Court Of Appeals
FOR THE EIGHTH CIRCUIT

No. 92-1372

Charles Dodge; Christine Y. Roberts, Appellants, v. Commissioner Of Internal Revenue, Appellee.	*	Appeal From The United States Tax Court

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Submitted: September 17, 1992

Filed: December 9, 1992

Before BEAM, Circuit Judge, FLOYD R. GIBSON, Senior Circuit Judge And MORRIS SHEPPARD ARNOLD, Circuit Judge.

BEAM, Circuit Judge.

Charles Dodge and Christine Y. Roberts jointly appeal a tax court judgment [1] holding them liable for back taxes and penalties. For reversal, appellants argue: (1) that the IRS assessment against them was a naked assessment not entitled to the presumption of correctness normally afforded IRS assessments; (2) that they identified a large percentage of the bank deposits as nontaxable, and, therefore, the burden of proof shifted to the IRS to show a taxable source for the disputed bank deposits -- a burden the IRS failed to meet; (3) that the IRS failed to prove that Dodge's insurance proceeds were not excludable from gross income under 26 U.S.C. § 104(a)(3); (4) that the tax court clearly erred in finding the taxpayers had not proven the nontaxable source of some of the disputed deposits; and (5) that no penalties were assessable against them.

We affirm in part and reverse in part.

I. BACKGROUND

Dodge and Roberts (the taxpayers) are retired and live together. Dodge is a veteran. He suffered from spinal meningitis in the 1960s, and receives veterans' disability benefits as a result of that illness. Dodge has previously been convicted of an imprisoned for tax violations and tax protesting activities. He is classified by the IRS as a tax protester. He and Roberts have maintained joint and separate accounts, and generally commingled their finances at least since 1981. In the fall of 1985, the IRS contacted Dodge about his failure to file income tax returns for the years of 1981 through 1984. Dodge claimed to be unable to provide the IRS with financial records because a fire had burned their house and, apparently, many of their financial records in January of 1984. As a consequence, the IRS used the indirect bank deposit method to reconstruct his income. Because the taxpayers' finances were commingled, and because Roberts had reported very little taxable income, even though bank records showed approximately $700,000 moving through their various

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[1] *Dodge v. Commissioner*, 96 T.C. 172 (1991).

accounts, Roberts was also investigated. She too provided no records, and the indirect bank deposit method was used to reconstruct her income. The commingling of the taxpayers' funds resulted in Roberts' classification as a tax protester for the purposes of the investigation.

The taxpayers had revenue during the relevant four-year period from veterans' and social security benefits, oil royalties, pension payments, and insurance proceeds. There was evidence that funds were also generated through real estate and personal loans between the couple, their friends, and various banks. Dodge and Roberts additionally deal in precious stones, used cars, and jewelry as a serious "hobby." During the years in question, Dodge carried from thirty to sixty hospital indemnification policies (HIPs) which pay a fixed amount per hospitalized day. For most of the period, he was also insured by Blue Cross/Blue Shield. From 1981 through 1984, Dodge was hospitalized at least seven times, collecting nearly $258,000 from his HIPs, and $5,124 from Blue Cross/Blue Shield.

The IRS issued statutory notices of deficiency to both taxpayers in January of 1987. Working with the IRS, Roberts and Dodge were able to identify the source of many of their deposits before trial. The parties remained at odds about the taxability of the insurance proceeds Dodge had received, due to the series of hospitalizations, about the identification of certain deposits, and about who had the burden of proof regarding the status of the unidentified deposits. After trial, the tax court found that Dodge's hospitalizations were not legitimate, that his health insurance claims were not made in good faith, and that he therefore could not exclude his insurance proceeds from gross income. [2] The tax court also assigned all revenue Dodge and Roberts could not show to have come from untaxable sources as gross income to either one

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[2] We understand the position of the IRS to be that Dodge may deduct the actual expenses of those hospitalizations which the tax court found were not due to actual illness or injury from his gross income. We take no position on this issue.

or the other. Finally, the tax court agreed with the IRS that: (1) Dodge was liable for penalties under 26 U.S.C. § 6651(a)(1) for unreasonably failing to file returns for the period in question; (2) Dodge was liable for penalties under 26 U.S.C. § 6654 for failing to pay any estimated tax for the relevant period; (3) both taxpayers were liable for penalties under 26 U.S.C. § 6653(a)(1) and (2) for negligent underpayment of tax; and (4) both taxpayers were liable under 26 U.S.C. § 6661(a) for substantial understatement of income, coupled with their failure to adequately disclose that income.

Dodge and Roberts appeal. We have jurisdiction under 26 U.S.C. § 7482.

II. DISCUSSION

A. The Assessment

"This court must accept the Commissioner's method of reconstructing income so long as it is rationally based." *Rowell v. Commissioner*, 884 F.2d 1085, 1087 (8th Cir. 1989). However, a "naked assessment" made without any foundation whatsoever, or without some predicate supporting evidence, is not entitled to the presumption of correctness. *Portillo v. Commissioner*, 932 F.2d 1128, 1133 (5th Cir. 1991). When taxpayers fail to file returns, or when they file returns substantially understating their income, and cannot produce records which provide the "[a]rithmetic precision ...originally and exclusively in [their] hands," an assessment is necessarily an estimate. *Rowell*, 884 F.2d at 1088. As long as the method for assessment is reasonable and logical, defaulting taxpayers may not complain of the inevitable inaccuracies in assessment their default occasions. *Id.* at 1087–88. Faced with nearly $700,000 deposited over a four-year period of time; no financial records; evidence pointing to an insurance speculation scheme; and no returns or returns reporting minimal income for the relevant period; the Commissioner had little choice but to use the indirect bank deposits method to reconstruct Dodge's and Roberts' income. We do not find the Commissioner's use of the indirect

bank deposits method, under the circumstances, to be anything less than reasonable and rationally based.

The taxpayers' claims that the assessment constituted arbitrary and irrational action because it initially purposely included some funds subsequently determined to be nontaxable must also fail. Dodge was classified as a tax protester, had been recently convicted of criminal tax offenses, had filed no returns while depositing large sums over a four-year period, claimed to have lost all records, and was apparently generating large sums through loans and insurance proceeds. Under these circumstances, it was completely logical to include in the assessment some deposits which might provide not to be income. We do not find any arbitrariness or irrationality in the Commissioner's evident determination that something was amiss, and that these sums most likely represented some form of actual income.

Nor does the inadvertent inclusion of some actually nontaxable deposits render the Commissioner's estimate a naked assessment. As noted, the assessment is intended to be an estimate. It is expected to be rational, not flawless. We note that after the initial assessment, the taxpayers and the Commissioner worked together over a period of several years to classify the deposits, and that the assessment was adjusted accordingly. The taxpayers' initial failure to provide this cooperation cannot now be used to attack the assessment as arbitrary.

The taxpayers also claim that the Commissioner acted arbitrarily and irrationally in assessing to both taxpayers the amounts held in joint accounts. Because the funds were commingled, it was rational for the Commissioner to assess the deposits as income to both parties. The taxpayers, not the Commissioner, were in a position to discern to whom the income should be assigned. It would have been irrational, and also unfair, to arbitrarily assign the joint funds to either Dodge or Roberts. The true owner would have no incentive to correct the situation, and the presumed owner would be at a disadvantage. By assigning the income to both account owners, the Commissioner avoided arbitrarily favoring one taxpayer over the other. The

Commissioner thus assured that both taxpayers were equally positioned and motivated in their quest to show the Commissioner and, ultimately, the trier of fact, the source of the deposits, and to whom they should be assigned.

B. The Burden of Proof

Once the deposits were shown to be in the nature of income, and to exceed what the taxpayers had reported as income, it became the taxpayers' responsibility to persuade the trier of fact that the deposits were nontaxable. *Calhoun v. United States*, 591 F.2d 1243, 1245 (9th Cir. 1978), *cert. denied*, 439 U.S. 1118 (1979); *Ruark v. Commissioner*, 449 F.2d 311, 312 (9th Cir. 1971). "Any other rule would burden the Government with investigating the many possible nontaxable sources of income..., a matter peculiarly within the knowledge of the defendant." *Zeeman v. United States*, 395 F.2d 861, 867 (2d Cir. 1968). The taxpayers were afforded the opportunity to show the tax court the error of the Commissioner's ways. The taxpayers' ability to identify a substantial proportion of the deposits before trial did not remove the presumption of correctness from the Commissioner's assessment as to those deposits still unidentified or disputed, nor did it shift the burden of proof to the Commissioner as to the tax status of those remaining deposits. *See id.* at 866–67; *United States v. Stonehill*, 702 F.2d 1288, 1294 (9th Cir. 1983) (rebutting presumption of correctness as to several items of a multiple assessment does not affect the presumed correctness of the rest of the assessment, unless a pattern of arbitrariness is demonstrated), *cert. denied*, 465 U.S. 1079 (1984). This result is especially appropriate in cases, such as this, where the Commissioner and tax court have classified a large portion of the belatedly identified deposits as taxable income. [3]

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[3] We note the taxpayers also argue that the burden shifted to the Commissioner because of "increased" deficiency assessments against Dodge for 1983 and 1984. Under the tax court's rules, this would normally be true. Tax Court Rule 142(a). However, the increases in question resulted from income being deleted from Roberts' liabilities and added to Dodge's, with the consent of all parties. Joint Appendix at 88. Such an adjustment has no relation to the

C. The Hospital Indemnification Policy Proceeds

Dodge maintained an "insurance program" which consisted of carrying from thirty to sixty hospital indemnification policies (HIPs). HIPs are insurance policies which pay the insured a fixed rate per day of hospitalization, regardless of amounts paid by other insurance companies. HIPs are typically available through the mail, and require no medical screening. It is not illegal to carry a large number of HIP policies. It may, in fact, be highly desirable for those who are at high risk of debilitating diseases and who are otherwise uninsurable. In addition, most major medical insurance policies exclude payment for "experimental" treatments, which may be the only hope for survival of a seriously ill person and which are often extremely expensive. Thus, even a person with traditional insurance might deem it prudent to carry a number of HIPs to cover the deductibles and exclusions of traditional insurance.

Under 26 U.S.C. § 104(a)(3) "amount received through accident or health insurance for personal injuries or sickness" are excluded from income. This exclusion has been interpreted to apply to all health or accident insurance benefits received by the taxpayer to combat the ravages of diseases or accidents. *Epmeier v. United States*, 199 F.2d 508, 511 (7th Cir. 1952); Rev. Rul. 69-154, 1969-1 C.B. 46; Rev. Rul. 58-602, 1958-2 C.B. 109, as modified by Rev. Rul. 68-212, 1968-1 C.B. 91. The taxpayer has the burden of proving that questioned proceeds fall within the exclusion. [4] Tax Court Rule 142. As the tax court correctly

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genesis of the deposits, and as such, had no effect on the burden of proof. A further stipulation of an arithmetic mistake resulted in Dodge's other "increase." Joint Appendix at 95. Likewise, this was not an increase in assessment which affected the burden of proof.

[4] We note that the taxpayers attempts to argue that the Commissioner had the burden of proving that Dodge's HIP proceeds were not within the statutory exclusion. This assertion is contrary to settled law. Tax Court Rule 142(a).

noted, personal injury or sickness, not hospitalizations or the receipt of insurance benefits, trigger the statutory exclusion.

We recognize the merit of the taxpayers' argument that the Commissioner should not be added to the proliferating ranks of nonprofessionals attempting to insert themselves into the doctor–patient relationship and to define appropriate care. However, when the evidence establishes that the taxpayer's claims for insurance benefits are not based on *any* actual sickness or injury, we find the Commissioner's categorization of those benefits as income to be correct. This is not to say that we would uphold a determination that insurance benefits received for an actual personal injury or sickness were income where the Commissioner merely disagreed with the appropriateness of the medical care given or considered the taxpayer to be overinsured.

We review the tax court's finding of fact under the clearly erroneous standard. *Hinckley v. Commissioner*, 410 F.2d 937 (8th Cir. 1969). [5] Under the clearly erroneous standard of review, we will uphold a finding unless, despite there being evidence in the record to support it, we are left with a "definite and firm conviction that a mistake has been made." *Anderson v. Bessemer City*, 470 U.S. 564, 575 (1985). The tax court found Dodge's "insurance program" to be his major source of income. During the relevant period, he carried Blue Cross/Blue Shield and thirty to sixty HIP policies. He fit the profile of an "insurance speculator," that is someone who purchases multiple HIPs and then seeks "friendly" doctors to admit him or her into a hospital on the basis of hard to diagnose head, neck, back, and soft tissue injuries. Dodge was hospitalized seven times during the 1981 through 1984

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[3] Contrary to the taxpayer's assertion, *Campbell County State Bank, Inc. v. Commissioner*, 311 F.2d 374, 377 (8th Cir. 1963), does not recognize exceptions to the clearly erroneous standard of review as applied to factual decisions of the tax court. The decision merely explains how the standard is applied in practice. *Id.* at 377, 379.

period in question, almost exclusively for back and neck pain after alleged falls. [6]

Six of Dodge's seven hospitalizations were for neck and back pain. Four admissions were by a physician who was a close personal friend and to whom the taxpayers had lent $50,000, sold an automobile, and sold jewelry. One admission was by a physician who was involved with Dodge in real estate investment, and in that hospitalization Dodge decided his own release date. One admission was after Dodge purportedly fell off a lawn mower in Arkansas and then flew to California for treatment. The tax court found Dodge's physician's and Dodge's own testimony regarding his injuries to be flatly incredible. A number of Dodge's HIP carriers successfully negotiated with Dodge to cancel their coverage after they discovered the amount of insurance he carried. Blue Cross/Blue Shield denied Dodge reimbursement for a large portion of his expenses as medically inappropriate. The postal authorities also investigated Dodge's insurance activities. In view of this record, the tax court did not clearly err in its determination that six of these hospitalizations, and the resultant insurance proceeds, were not related to actual sickness or injuries. Therefore the tax court's classification of those proceeds as outside of the statutory exclusion is correct as to six of the seven hospitalizations.

However, even "insurance speculators" may suffer legitimate or catastrophic illnesses; when that occurs section 104(a)(3) operates to exclude the benefits they receive due to illness or personal injury, just as it would for any other taxpayer. That the benefits may exceed the taxpayer's actual immediate medical expenses is of no consequence under the plain language of the statute, so long as the illness is genuine. The taxpayer may well need the benefits for future expenses major medical insurance will not cover, or for living and home care expenses while incapacitated. To the extent the Commissioner asserts that benefits

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[6] We note that the record shows Dodge continued to be frequently hospitalized after purported falls in the years following 1984. Joint Appendix at 214.

received in excess of actual medical expenses are not excluded from income by section 104(a)(3), we disagree. The plain language of the statute excludes all "amounts received through accident or health insurance for personal injuries or sickness." 26 U.S.C. § 104(a)(3). Since Congress did not limit the exclusion to actual expenditures when writing the statute, we will not do so in Congress' stead. [7]

The tax court did not interpret the statute otherwise, but grounded its rulings against Dodge on its factual finding that Dodge had not suffered any legitimate illness or injury. As noted above, we do not find those rulings to be clearly erroneous for six of Dodge's hospitalizations. However, the seventh hospitalization, for a perforated colon, evidently a side effect of a biopsy

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[7] The purpose of the statute, as well as its plain language, supports our interpretation. The ravages of disease and accident are not confined to the medical expenses of the moment, but may stretch into months or years. The need for expensive and/or experimental treatment (which major medical policies routinely exclude) may arise long after the event triggering benefits, and long after the taxpayer has lost any previous medical coverage or the ability to be gainfully employed. These are the concerns which support the statutory exclusion of benefits occasioned by accident or illness from income. *See Epmeier*, 199 F.2d at 508. These are also the concerns motivating most taxpayers who purchase multiple HIPs.

For example, the Insurance Commission of the taxpayers' state recommends that people at risk for serious prolonged illnesses such as AIDS or cancer purchase multiple HIP policies. Joint Appendix at 116–118, 128 (testimony of assistant insurance commissioner). Such high risk people cannot predict which illness will be the catastrophic one that permanently removes them from the work force, or which will be the one that requires experimental treatment. They therefore cannot predict when they should start carrying more HIP coverage to provide them with funds for the long uncertain period ahead. Joint Appendix at 116–118. Neither can the average taxpayer predict when he or she will unexpectedly suffer a catastrophic health problem. *Id.* Nor can the IRS Commissioner make any sort of reliable finding as to when the ravages of illness are finally over, or when the taxpayer may be sure to incur no more expenses due to a particular illness, rendering any benefits received beyond that level a pure windfall. For these reasons, as well as the statute's plain language, we interpret the statute literally to exclude from income all amounts "received through accident or health insurance for personal injuries or sickness."

performed in anticipation of a hemorrhoidectomy, is clearly the result of an actual illness or accident. Even if the tax court chose not to credit the testimony of Dodge's physician, which is its prerogative, Dodge's hospital and medical bills verify that he underwent the surgery. Joint Appendix 529–38. This leads us to the definite and firm conviction that the tax court made a mistake in finding no legitimate illness or injury triggered this hospitalization, and that the Commissioner was unreasonable to assert otherwise. Accordingly, the tax court clearly erred in not excluding from the taxpayers' income those amounts Dodge received from health or accident insurance due to the biopsy, perforation, and surgery underlying the May and June 1982 hospitalization. This error does not affect the validity of the rest of the assessment. *Stonehill*, 702 F.2d at 1294.

D. Identification Of Other Questioned Deposits.

Since these disputed deposits have the nature of income, the burden was on the taxpayers to show whether and to what extent they derived from nontaxable sources. *See Calhoun*, 591 F.2d at 1245; *Ruark*, 449 F.2d at 312. The taxpayers claim that they have shown the source and nature of some of these deposits, and that the tax court erroneously failed to adjust the assessment to that extent. We review the tax court's determination that the taxpayers failed to adequately identify the disputed deposits under the clearly erroneous standard. *Hinckley*, 410 F.2d at 937.

One of the principal disputes in this category is a $50,000 loan between the taxpayers and their primary physician. The tax court explicitly recognized the existence of the loan, and relied on the existence of the loan between the taxpayers and Dodge's physician to discredit Dodge's hospitalizations. *Dodge*, 96 T.C. at 177. Having relied, to the taxpayers' detriment, on oral testimony that they borrowed $50,000 from a credit union to fund a handshake loan to Dodge's physician, the tax court may not ignore the clear evidence that ten subsequent monthly checks of $1,000 from the physician to the taxpayers, and the $45,000 dollar lump sum which followed, were in repayment of the loan. Joint Appendix at 1273, 1299–1300. To find otherwise is unreasonable,

and against the clear weight of the evidence. The tax court's finding on this issue is therefore clearly erroneous. *See Campbell County State Bank, Inc. v. Commissioner*, 311 F.2d 374, 377 (8th Cir. 1968). Of course, the funds the physician admittedly paid Dodge and Roberts for an engagement ring and an automobile are not within the parameters of the repayment of the loan, and the taxpayers do not claim otherwise.

We are cognizant that a taxpayer without records or returns may not insist on arithmetic precision, but when the tax court finds that certain deposits were generated by sales of automobiles and jewelry, and also determines a basis for those items, the assessment must be adjusted accordingly. *Dodge*, 96 T.C. at 174–75, 182. Although the taxpayers complain that the tax court's ruling will result in their being taxed doubly for those items, we are confident that when the tax court assigned the proceeds from the taxpayers' sales of vehicles and jewelry to their respective tax liabilities, *id.* at 182, it intended that the Commissioner adjust the assessment as to those items where both a sales price and a basis had been found, *id.* at 174–75, to reflect the net income to the taxpayers. We are likewise confident that the Commissioner will comply with the tax court's evident intent.

The taxpayers argue strongly that they presented adequate evidence to show that several more of the disputed deposits were loan substitutions and thus not taxable. However, we do not find, on the record before us, that the tax court clearly erred in finding the taxpayers failed to meet their burden of proof as to the rest of the disputed deposits. *See Stonehill*, 702 F.2d at 1294.

E. Penalties.

The tax court imposed penalties on Dodge for failing to file Federal income tax returns without reasonable cause under 26 U.S.C. § 6651(a)(1) and failing to pay estimated income tax under 26 § U.S.C. 6654. Penalties were imposed on both Dodge and Roberts under 26 U.S.C. § 6653(a)(1) and (2) for negligently underpaying their taxes, and under 26 U.S.C. § 6661(a) for

substantially understating their income with no substantial authority for their tax treatment of the item resulting in the understatement.

We concur that the tax court's well-reasoned application of these penalties, and see no need to repeat it here. We therefore affirm these penalties, which are to be applied after the taxpayers' underlying tax liability has been adjusted in accordance with this opinion.

III. CONCLUSION

For the reasons stated above, we affirm the tax court's decision, except with respect to benefits received due to Dodge's hospitalization for a perforated colon and hemorrhoidectomy, and with respect to the classification of the repayment of the taxpayers' $50,000 loan to their physician as taxable income. As to those two items, we reverse and remand for further proceedings not inconsistent with this opinion. The penalties imposed are affirmed, and are to be applied after recalculation of the taxpayers' underlying tax liability in conformance with this opinion.

A true copy.

Attest:

CLERK, U.S. COURT OF APPEALS, EIGHTH CIRCUIT

APPENDIX B

96 T. C. No. 9

UNITED STATES TAX COURT
CHARLES DODGE AND CHRISTINE Y. ROBERTS,
Petitioners
v.
COMMISSIONER OF INTERNAL REVENUE,
Respondent

Docket No. 9830-87.

Filed February 12, 1991.

Petitioner Charles Dodge engaged in an insurance speculation scheme under which he purchased an excessive number of hospital indemnification policies. *Held*: Petitioners have not established that the proceeds received under the hospital indemnification policies related to actual personal injuries or sickness. Accordingly, the proceeds are not excludable under § 104(a)(3), I.R.C. 1954, as amended.

Eugene G. Sayre, and *Virginia Joyce Kinkead*, for the Petitioners.

Paul M. Kohlhoff, for the Respondent.

OPINION

SWIFT, *Judge*: Respondent mailed Petitioners separate notices of deficiency, each dated January 16, 1987, determining deficiencies in and additions to Petitioners' respective individual Federal income taxes for 1981, 1982, 1983, and 1984, as follows:

Charles Dodge

Year	Deficiency	Additions to Tax, Secs. [1]				
		6651(a)(1)	6653(a)(1)	6653(a)(2)	6654	6661(a)
1981	$14,499.10	$ 3,624.78	$ 724.96	*	$1,110.99	$ .00
1982	23,752.12	5,938.03	1,187.61	*	2,312.48	5,938.03
1983	68,072.79	17,018.20	3,403.64	*	4,165.57	17,018.20
1984	63,050.44	15,762.61	3,152.52	*	3,964.06	15,762.61

* Fifty (50) percent of the interest attributable to the portion of the underpayment that is due to negligence or intentional disregard of the rules and regulations.

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[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954, as in effect for the years in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure.

Christine Y. Roberts

Year	Deficiency	Additions to Tax, Secs.		
		6653(a)(1)	6653(a)(2)	6661(a)
1981	$ 40,975.41	$2,048.77	*	$ 6,844.79
1982	27,379.15	1,368.96	*	6,844.79
1983	69,368.84	3,468.44	*	17,342.21
1984	123,626.95	6,181.35	*	30,906.74

* Fifty (50) percent of the interest attributable to the portion of the underpayment that is due to negligence or intentional disregard of the rules and regulations.

The primary issues for decision are: (1) Whether, under section 104(a)(3), Petitioner Charles Dodge (Dodge) may exclude from income proceeds received under an insurance speculation scheme; (2) whether deposits to Petitioners' bank accounts during the years at issue represent unreported income to either Petitioner; (3) whether Petitioners are entitled to certain interest deductions under section 163(a); and (4) whether Petitioners are liable for the various additions to tax determined in their respective notices of deficiency.

FINDINGS OF FACT

Some of the facts have been stipulated, and are so found. Petitioners resided in Mountain Home, Arkansas, at the time they filed their Joint Petition.

Following his discharge from the military in 1955, Petitioner Charles Dodge worked at numerous jobs in various states. He worked as a diesel mechanic, as an insurance salesman, and as a minister. He also worked on the family farm, and he promoted tax shelters.

Dodge married, and raised a family. In the mid-sixties, Dodge was diagnosed as having spinal meningitis, and he was hospitalized in a Veterans' hospital in Dallas, Texas. Because of the illness, Dodge now suffers partial facial paralysis, and a partial hearing loss. Dodge receives Veterans' disability benefits as a result of this illness. On February 9, 1979, Dodge's wife died from a brain aneurysm.

As a result of two earlier cases involving Dodge and Dodge's failure to properly file Federal income tax returns for a number of years, including the years at issue herein, Dodge has been identified on Respondent's records as a tax protester. Dodge was convicted, in 1976, of eight counts of violating § 7205, and eight counts of violating 18 U.S.C. § 2 (1988). With respect to the convictions, Dodge served eight concurrent one-year prison terms.

In a previous case before this Court, involving unreported income and Respondent's deficiency determinations based on the bank deposits method of proof, Dodge was warned that the filing of further frivolous or unwarranted cases could result in the imposition of a penalty under § 6673. *Podge v. Commissioner*, T.C. Memo. 1983-431. At issue in that case was Dodge's unreported income from speaking at tax protester meetings, and from selling tax protester material.

Prior to her association with Dodge, Petitioner Christine Roberts (Roberts) acquired various houses, resort and rental properties in Arkansas and Texas, fur coats, diamond jewelry, and bank accounts. Each year, Roberts also received pension benefits from Braniff Airways, and oil royalties from Scurlock Oil Company.

In 1980, Petitioners began living together in Roberts' home in Lancaster, Texas. In the summer of 1981, Roberts sold her home in Texas, and Petitioners moved to Arkansas where they jointly purchased a home in Mountain Home.

During the years in issue, Petitioners were not employed. The sources of their income were Veterans' and Social Security benefits, oil royalties, payments from pension plans, insurance proceeds, and proceeds from the sale of jewelry and automobiles. Petitioners maintained several joint bank accounts at various institutions. Roberts also maintained one account in her name.

During the years in issue, Petitioners jointly purchased, and sold or exchanged the following automobiles:

Vehicle	Date Purchased	Cost	Date Sold	Amount Received
1978 Lincoln Town Car	December, 1982	$ 5,000	Fall, 1983	$ 5,500
1966 Ford Mustang	Spring, 1982	1.50 Ct. Diamond	July, 1983	3,500

Vehicle	Date Purchased	Cost	Date Sold	Amount Received
1978 Chevy 1/2 Ton Truck	July, 1983	3,225	August, 1983	3,650
1978 Cadillac Sedan Seville	July, 1983	5,000	Fall, 1983	4,500
1978 Cadillac Fleetwood	June, 1983	4,500	June, 1983	6,000
1978 Lincoln Mark V	1981	6,000	Spring, 1983	Trade
1982 Lincoln Continental	July, 1983	13,000	March, 1984	Trade
1979 Chevy Tow Truck and 1982 Cree RV	Spring, 1983	19,000 and 1978 Lincoln Mark V	February, 1984	25,500
Chevy Suburban	June, 1984	3,000	July, 1984	3,000
1978 Lincoln Town Car	November, 1984	4,500	November, 1984	4,500

During the years in issue, Petitioners also purchased and sold the following items of jewelry:

Jewelry	Date Purchased	Cost	Date Sold	Amount Received
1.50 Ct. Diamond Gold Mounting	Unknown	$3,800	Spring, 1982	$5,000
1.50 Ct. Diamond Gold Mounting	January, 1982	2,100	Spring, 1982	1966 Ford Mustang
1.75 Ct. Diamond Gold Mounting	Spring, 1983	3,500	Spring, 1983	5,000
1.50 Ct. Diamond Gold Mounting	Spring, 1983	3,500	Summer, 1983	4,500

Jewelry	Date Purchased	Cost	Date Sold	Amount Received
4.23 Ct. Diamond Gold Mounting	Unknown	6,650	Summer, 1983	9,250
1.18 Ct. Diamond Gold Mounting	January, 1982	2,800	December, 1983	3,000
Marquise Diamond Gold Mounting	Spring, 1983	3,800 or 4,000	December, 1983	5,000
2.45 Ct. Diamond Gold Mounting	February, 1984	3,000	March, 1984	3,500
2.05 Ct. Diamond	1983	7,000	May, 1984	8,500
2.07 Ct. Diamond Gold Mounting	Spring, 1983	5,200	September, 1984	5,000

Proceeds from the sale of automobiles and jewelry appear to have been deposited into Petitioners' joint bank accounts.

The source, however, of the majority of the funds deposited into Petitioners' bank accounts was what Dodge has described as his "insurance program." Dodge's insurance program consisted of a scheme referred to appropriately in the insurance industry as insurance speculation. Insurance speculation, in the context of this case, involves the purchase of multiple hospital indemnification policies (sometimes referred to as HIP policies, HIPs, and HIP), which policies typically pay $25 to $100 for each day an insured is hospitalized, regardless of the insured's actual hospital and other medical expenses.

HIP policies typically are purchased so that the insured will have funds with which to cover the insured's deductible, the copayments, or the excess charges arising from a hospitalization that are not covered by the insured's major medical insurance policy. In some circumstances, HIPs are the sole source of insurance for individuals uninsurable through major medical plans.

HIPs are marketed by insurance companies through mass media such as radio, television, and direct mail. HIP applications typically require little or no underwriting information, and often guarantee acceptance and renewal.

Individuals who purchase HIPs as part of an insurance speculation scheme typically purchase multiple HIPs, and then arrange to be hospitalized for head, neck, back, and other purported soft-tissue injuries that are difficult to diagnose, and that have no external signs or symptoms. The injuries complained of usually arise from alleged slip-and-fall accidents that are unwitnessed.

To carry off their scheme, insurance speculators typically seek "friendly" doctors who admit them to hospitals with little or no pre-admission diagnosis, and who unnecessarily prolong the hospital stay.

During each of the years at issue, Dodge purchased the following number of HIP policies from numerous companies, with the total daily benefit coverage as shown:

Year	Number Of HIPs	Number Of Insurance Companies	Amount Of Daily Coverage
1981	33	26	$ 873
1982	45	22	2,127
1983	61	35	2,657
1984	47	25	2,075

During 1982 through 1984, Dodge also had a major medical reimbursement policy with Blue Cross/Blue Shield of Arkansas (Blue Cross).

During the years at issue, in order to earn substantial

income from his numerous HIP policies, Dodge had himself admitted to the various hospitals on the occasions, and for the alleged reasons indicated below:

Date Of Hospitalization	Hospital	Alleged Reason For Hospitalization	Admitting Physician
03/16/81–04/06/81	Francis A. Bell Memorial Hospital Ishpeming, Michigan	Slipped on ice while exiting car. Neck and back pain.	Dr. W. G. Schroeder
05/25/82–06/18/82	Francis A. Bell Memorial Hospital Ishpeming, Michigan	Hemorrhoidectomy, perforated bowel, and peritonitis.	Dr. W. G. Schroeder
08\05\83–08/13/83	Baxter County General Hospital Mountain Home, Arkansas, transferred on 08/06/83 to St. John's Regional Health Center Springfield, Missouri	Fell down stairs, and suffered neck and back pain, and weakness in extremities.	Dr. Bert E. Park, and Dr. William R. Truitt
08/19/83–09/02/83	Francis A. Bell Memorial Hospital Ishpeming, Michigan	Headache, pain in neck and left arm, and weakness and numbness.	Dr. W. G. Schroeder

Date Of Hospital-ization	Hospital	Alleged Reason For Hospital-ization	Admitting Physician
11/03/83-11/10/83	Francis A. Bell Memorial Hospital Ishpeming, Michigan	Neck and back pain stemming from fall down stairs on 08/05/83.	Dr. W. G. Schroeder
04/27/84-05/11/84	Lakeside Community Hospital Incline Village, Nevada, transferred on 05/07/84 to Washoe Medical Center Reno, Nevada	Back pain, depression, and anxiety.	Dr. W. D. Brodie, and Dr. J. P. Maloney at Lakeside and Dr. Hale Henson, and Dr. Malcolm Bacchus at Washoe
08/24/84-09/02/84	Loma Linda Community Hospital Loma Linda, California	Fell off lawn mower, and hurt back and legs.	Dr. E. T. Dombrowski, and Dr. Kern H. Pihl

As noted, Dr. Schroeder was the admitting physician for each of Dodge's four stays at Francis A. Bell Memorial Hospital. Dr. Schroeder was a personal friend of Dodge and had borrowed $50,000 from Dodge. Dr. Schroeder also had purchased from Dodge an automobile and a diamond engagement ring. In 1983, Dr. Schroeder admitted Dodge twice to the hospital for, the same alleged fall and with respect to which Dodge already had been treated and released by yet another hospital.

Dr. Douglas Brodie, who on April 27, 1984, admitted Dodge to Lakeside Community Hospital, was involved with Dodge in a 600-acre real estate transaction. After being transferred on

May 7, 1984, to the Washoe Medical Center in Reno, Nevada, Dodge himself decided when he was to be discharged.

After allegedly falling off his lawn mower in Arkansas in August of 1984, Dodge flew to California to be hospitalized, instead of going to a local hospital in Arkansas.

In 1982, 1983, and 1984, and with respect to the above hospitalizations, Dodge received, under his major medical reimbursement policy with Blue Cross, reimbursements totaling $5,124. Significant additional expenses relating to the above hospitalizations with respect to which Dodge sought reimbursement under his Blue Cross major medical reimbursement policy were denied as inappropriate medical expenses.

In addition to the insurance proceeds received by Dodge under his Blue Cross major medical reimbursement policy, Dodge received very substantial amounts under his many HIP policies. The following figures reflect total medical expenses Dodge incurred each year in connection with his hospitalizations, the total proceeds he received each year under his HIP policies, and the net HIP proceeds petitioner pocketed:

Year	Hospital Expenses	HIP Proceeds	Net Proceeds *
1981	$ 4,000	$ 17,848	$ 13,848
1982	6,312	31,823	25,511
1983	8,233	81,423	73,190
1984	10,900	126,271	115,371
Total	$29,445	$257,365	$227,920

* The net proceeds and other figures in this schedule do not take into account premiums Dodge paid for the HIP policies, the amounts of which are not in the record, nor the $5,124 Dodge received under his Blue Cross major medical reimbursement policy.

At various times throughout the years at issue, a number of the insurance companies discovered that Dodge was carrying an excessive number of HIP policies and an excessive amount of HIP coverage. They negotiated with Dodge for cancellation of the HIP policies they had issued to him. Dodge agreed not to apply with those companies for any new HIP policies, and they paid Dodge a fixed amount for the cancellations.

Insurance speculation is regarded as a crime under Federal and State law. Dodge, however, was not prosecuted for engaging in insurance speculation during the years in issue.

In January of 1984, petitioners' home in Mountain Home, Arkansas, was destroyed by fire. Petitioners' home was insured for $145,000 on the dwelling and $112,000 on the contents. The insurer paid $143,208 to the mortgage holder with respect to the fire damage and $60,000 to petitioners with respect to the contents. Attorneys' fees incurred by petitioners in connection with negotiations with the insurer concerning the fire damage 12 were $15,500. Proceeds from the fire insurance were deposited into petitioners' various joint bank accounts.

Dodge failed to file Federal income tax returns with respect to each year at issue. Roberts timely filed an individual Federal income tax return with respect to each year at issue. Roberts, however, did not include in her tax returns any income from the sale of jewelry or automobiles, nor did she include any of the proceeds from the HIP policies on her income tax returns.

Roberts claimed interest deductions on her 1981, 1983, and 1984 tax returns in the respective amounts of $5,715, $1,000, and $1,032.

On audit, respondent analyzed bank statements and deposit slips from petitioners' various bank accounts to determine petitioners' separate taxable income. Use of the bank deposits method by respondent was necessitated because petitioners lacked financial records for the years at issue. Apparently, petitioners' records were destroyed in the 1984 fire that destroyed their

home. Respondent treated all of the proceeds Dodge received on his HIP policies as taxable income to Dodge.

The parties have categorized the deposits into petitioners' bank accounts and the source thereof as follows:

Source	1981	1982	1983	1984
Nontaxable	$ 460	$19,638	$133,992	$ 32,873
Insurance proceeds	17,848	31,823	81,423	126,271
Miscellaneous	------	15,784	22,229	114,076
Unknown	20,707	2,768	56,755	13,151
Reported by Roberts on her tax returns	126	751	1,552	1,229

On audit, respondent determined that the deposits characterized as "Miscellaneous," and "Unknown" were taxable income either to Dodge or to Roberts.

OPINION

Insurance Proceeds

Section 104(a)(3) excludes from income "amounts received through accident or health insurance for personal injuries or sickness."

Dodge argues that the insurance proceeds he received under his HIP policies are excludable from income under section 104(a)(3) because they were received with respect to his many alleged injuries and sicknesses and resulting hospitalizations. In support of his position, Dodge cites *Deming v. Commissioner*, 9 T.C. 383 (1947), and Rev. Rul. 69-154, 1969-1 C.B. 46. *Deming*, however, involved the deductibility of medical costs and whether the taxpayer was reimbursed through insurance. This is not the issue before us and lends no support to Dodge's position. The issue addressed in Rev. Rul. 69-154 was whether certain insurance

proceeds were attributable to the taxpayer's cost or to the employer's cost. Insurance speculation was not involved.

Based on the evidence before us, we cannot, and do not, conclude that the proceeds Dodge received under his HIP policies during the years at issue related to actual, legitimate personal injuries or sickness. The testimony of Dodge and Roberts concerning the alleged injuries and sickness lacked credibility. Dr. Schroeder's testimony also lacked credibility. Further, the medical and hospital records offered by Dodge, on the facts of this case, do not establish Dodge's injuries or sickness.

The circumstantial evidence in this case raises serious questions concerning the legitimacy of Dodge's alleged injuries and sickness. The number of hospital admissions, the nature of the alleged injuries and sickness, the location of the hospitals, the relationship of Dodge with his doctors, combined with the existence of the multiple HIP policies and petitioners' lack of credibility support our conclusion.

The statutory language requires that to be excludable, the amounts must be paid "for personal injuries or sickness." Sec. 104(a)(3). The mere fact that the amounts in question in this case were paid to Dodge by insurance companies under HIP policies does not establish that such amounts, in fact, related to actual injuries and sickness, and petitioners have not established that the amounts did relate to any such actual injuries and sickness. To the contrary, the evidence strongly suggests that many if not all of the hospital admissions did not relate to actual injuries or sickness, but were contrived so that Dodge could file claims under his many HIP policies. Rule 142(a).

Respondent did not argue in this case that Dodge committed fraud in connection with his insurance speculation scheme, and our conclusion on this issue is not intended as a finding that fraud occurred. Respondent, however, did not concede that the HIP proceeds Dodge received related to actual personal injuries or sickness.

Our analysis herein is based, in part, on the principle that the mere fact insurance companies pay claims under medical insurance policies does not necessarily result in an exclusion under section 104(a)(3) of the proceeds received by a taxpayer under the policies. Where the evidence establishes that claims made by a taxpayer under medical insurance policies were not legitimate and not made in good faith, or that the claims did not relate to actual injuries or sickness of the taxpayer (or where the evidence raises significant questions concerning the above), the exclusion under section 104(a)(3) is not available. This result is particularly appropriate and applicable where the taxpayer has the burden of proof under Rule 142(a), as do petitioners herein.

For the reasons stated, the total insurance proceeds Dodge received each year on his HIP policies represent income, and are not excludable under section 104(a)(3).

Unidentified and Miscellaneous Deposits

Because petitioners produced no financial records, respondent used the bank deposits method to determine petitioners' separate income for each year. In summary, the bank deposits method reconstructs a taxpayer's income through an examination of deposit and withdrawal transactions involving a taxpayer's bank accounts. The burden, generally, is on taxpayers to show that the bank deposits were derived from nontaxable sources. Rule 142(a); *Reaves v. Commissioner*, 31 T.C. 690, 718 (1958), affd. 295 F.2d 336 (5th Cir. 1961); *Romer v. Commissioner*, 28 T.C. 1228, 1244 (1957).

Petitioners appear to argue that because the majority of the deposits to their bank accounts have been identified, we should assume that the remaining unidentified deposits are not taxable. Having identified the majority of the deposits, however, as constituting taxable income, if any inference is to be drawn therefrom, it would be that the remaining unidentified deposits also constitute, and should be treated as, taxable income. Petitioners have failed to show that the remaining unidentified deposits and the miscellaneous deposits constituted nontaxable income, and

petitioners have not overcome the presumption that they are taxable. *Zeeman v. United States*, 395 F.2d 861, 866–867 (2d Cir. 1968).

A portion of the unidentified and miscellaneous deposits is attributable to petitioners' sales of automobiles and jewelry. Income derived from these two activities will be divided equally between Dodge and Roberts. The balance of the unidentified and miscellaneous deposits into petitioners' joint bank accounts will be included in Dodge's income, except for the following deposits, which will be included in Roberts' income:

Year	Account Number	Amount	Identified As
1982	044-872-9	$2,684.97	Check to Roberts
1983	044-872-9	89.44	Check to Roberts
1984	5940661	242.34	Check endorsed to Roberts

The unidentified and miscellaneous deposits made into Roberts' individual bank account at Home Federal Savings and Loan will be included in Roberts' income, except for the $1,000 check from Dr. Schroeder to Dodge, which will be included in Dodge's income.

Interest Deductions

Interest paid on indebtedness within a taxable year is allowed as a deduction under section 163(a). The parties have stipulated that petitioners paid interest of $5,715.00, $7,795.98, $23,137.04, and $11,846.91 in 1981, 1982, 1983, and 1984, respectively. The issue remaining regarding these payments is the allocation thereof between petitioners. Based on the record, the interest payments that were claimed by Roberts on her 1981, 1983, and 1984 tax returns are deductible by her. The balance of the interest payments that were made each year are deductible by Dodge.

Additions to Tax and Statute of Limitations

Petitioners dispute the additions to tax. Additions to tax under section 6651(a)(1) are imposed for failure to timely file Federal income tax returns. Dodge was determined to owe the addition to tax under section 6651(a)(1) because he filed no returns for 1981, 1982, 1983, and 1984. Taxpayers may be relieved of this addition to tax if it is shown that the failure to timely file was due to reasonable cause and not to willful neglect.

Dodge's explanation for not filing returns is that he did not believe any were necessary. Dodge, however, had substantial income from the sale of automobiles, jewelry, and the proceeds from insurance speculation. There is no legitimate basis for Dodge's alleged belief that he was not required to file Federal income tax returns, and we sustain the additions to tax under section 6651(a)(1).

Section 6654 imposes an addition to tax on taxpayers who fail to pay estimated income tax. Section 6654 additions as to the years at issue are mandatory regardless of extenuating circumstances. *Grosshandler v. Commissioner*, 75 T.C. 1, 21 (1980). Dodge is liable for the additions to tax under section 6654.

Respondent determined that both petitioners were liable under section 6653(a)(1) and (2) for additions to tax due to negligence on the underpayments. For purposes of section 6653, the standard for determining negligence is a lack of due care or failure to do what a reasonable and ordinarily prudent person would do under the circumstances. *Zmuda v. Commissioner*, 731 F.2d 1417, 1422 (9th Cir. 1984), affg. 79 T.C. 714 (1982); *Neely v. Commissioner*, 85 T.C. 934, 947 (1985).

Petitioners' underpayment of tax was clearly due to negligence, if not the intentional disregard of rules and regulations. Under the circumstances of this case, Dodge's complete failure to file tax returns for the years in issue was not reasonable. Although Roberts filed returns, she failed to report

income that a reasonable person would have reported under the circumstances, namely proceeds from the sale of automobiles and jewelry.

We hold that the additions to tax determined under section 6653(a)(1) and (2) are sustained and shall be computed based on the entire deficiencies with respect to both petitioners.

The addition to tax under section 6661(a) applies when the taxpayer has substantially understated his income tax. Taxpayers may reduce the amount of the understatement to which this addition is applied by adequate disclosure on the tax returns of the income or transactions in question or by having substantial authority for the tax treatment of the item.

Dodge filed no tax returns on which a disclosure could have been made, and Roberts failed to make a disclosure on her returns. Neither petitioner has offered substantial authority that the income they received over the years in issue should not be taxed. The additions under section 6661 shall be assessed against the entire understatements for each year.

Roberts raises the three-year statute of limitations under section 6501(a) for 1981 and 1982. Respondent asserts the applicability of the six-year statue of limitations under § 6501(e). This issue turns solely on the computations under Rule 155 and whether such computations reflect omissions of gross income on Roberts' tax returns, as filed, in excess of 25 percent of the amount of gross income stated in the returns.

All other arguments made by petitioners have been considered
and are without merit.

Decision will be entered under Rule 155.

APPENDIX C

United States Court Of Appeals
FOR THE EIGHTH CIRCUIT

No. 92-1372

Charles Dodge; Christine Y. Roberts,	*	
Appellants,	*	
	*	Appeal from the United
	*	States
v.	*	Tax Court
	*	
Commissioner of Internal Revenue,	*	
	*	
Appellee.	*	

The suggestion for rehearing en banc is denied. The petition for rehearing is also denied.

January 20, 1993

Order Entered at the Direction of the Court:
Clerk, U.S.Court of Appeals, Eighth Circuit

APPENDIX D

Partial Transcript Of Opening Statement Of Petitioners' And IRS' Counsel In Tax Court Proceeding (March 2, 1989)

MR. SAYRE: As we stated in our trial memorandum, Your Honor, the issues involve an audit of the years 1981 through 1984 of the income tax returns filed by Christine Roberts, and the financial records of Charles Dodge.

* * *

These years involved the primary question of the classification of health and accident insurance proceeds, and the Petitioners' claim that those are excluded from gross income under the specific provisions of Section 104(a)(3) of the code.

* * *

Petitioner Dodge purchased a number of policies -- hospital indemnity policies, which, as I indicated, the code and the rulings of the Service state are excludable from income.

The case was worked as a bank deposits case. The 90-day letter was issued, and the first time that counsel was involved was shortly before -- two or three weeks before the 90-day period ran for filing.

We requested, formally, a withdrawal under 6212(d), with an attempt to work with the examination division of identifying the source of most of these as insurance proceeds, and that was formally denied, and the Petition was filed.

* * *

But, only on September 8, of last year, for the first time -- at that time the trial was scheduled on October 17 -- did the Government raise, as an issue, that the proceeds received by Mr. Dodge from the health indemnity policies were gross income to him -- did not qualify for the specific statutory exclusion, and were includable as gross income under the theory that this was an attempt to make a profit, and that he was entitled to deductions for the insurance premiums paid, and deductions for the medical expenses incurred.

We have found absolutely no ruling ever issued by the Service to this effect, and as we stated in the trial memorandum, we believe the action is so arbitrary and capricious, four (4) years after the period -- the last taxable period to raise this issue, that we are requesting the Court to consider the award of costs if the Court finds for the Petitioners.

(Tr. 5-8)

* * *

MR. KOHLHOFF: May it please the Court, Your Honor, I would agree with most everything that Mr. Sayre said.

This is -- this case is based on a bank deposits method. We have gone to the trouble of trying to identify as many deposits -- the source of those deposits as possible. Some remain unidentified.

The vast majority appear and, we would agree, are deposits of insurance proceeds. There are some cash deposits that we have not been able to identify the source of, and we dispute whether they are loan proceeds or sale proceeds.

Concerning the insurance proceeds issue, which is the major issue here, the facts, I believe, will show that -- and we do feel that this may possibly be a case of first impression -- we believe the facts will show that in 1980, or thereabout, Mr. Dodge

began purchasing health and accident insurance policies. These policies typically pay $25 to $100 a day for each day of hospitalization.

We have been able to identify, that in 1981, he had 31 -- 33 of these policies with 26 different companies. In 1982 he had 46 policies with 23 different companies. In 1983 he had 62 policies with 37 companies, and in 1984 he had 48 policies with 26 companies.

* * *

Mr. Dodge has generated a great amount of income from these -- from filing claims with these insurance policies based on his hospitalizations. In 1981, he earned approximately $40,000. In 1982, he earned approximately $60,000; in 1983, approximately $100,000; and in 1984, approximately $95,000.

In other words, it paid for Mr. Dodge to become hospitalized, and it paid very well. These amounts that he received are far in excess of Mr. Dodge's hospitalization and medical expenses.

We believe that the evidence will show that Mr. Dodge was operating a scheme for profit typically referred to as insurance speculation. All the characteristics of insurance speculation are present in this case.

Respondent's position, with respect to Section 104, is first that, given the facts, Mr. Dodge was not buying insurance within the meaning of the statute. He was purchasing these policies with the intent to profit from them.

Therefore, there was no shifting of the risk from the insured to the insurer, and, therefore, this does not constitute insurance. These -- we believe that Mr. Dodge took out these policies with the intent to become hospitalized.

Secondly, we believe that this is not the type of situation Congress intended when they created the exclusion provided for in § 104. Section 104 was intended to exempt from taxation amounts a taxpayer received as compensation for losses occasioned by an illness or accident, compensation that makes the taxpayer whole again.

Here, the evidence, I believe, will clearly show that Mr. Dodge was able to generate a great amount of economic wealth from these policies.

Finally, because this type of scheme is an abuse of the exclusion provided in § 104, and because insurance speculation can involve criminal conduct, Respondent would argue that it is against public policy to allow Mr. Dodge -- to let his profits from these policies go untaxed.

* * *

THE COURT: Thank you.

MR. SAYRE: Mr. Kohlhoff, before you leave -- I would like to make absolutely sure, Your Honor, of one important position of the Government in this case, because they have alleged, in the last few days, and Mr. Kohlhoff told the Court that insurance speculation involves criminal conduct.

And, we have indicated and are prepared to put an official of the state insurance department on as to what are the requirements for the companies to be licensed in the purchase of such policies.

But nowhere, even from September 8 in, has there ever been question....I want to make sure that the Government is not in any way alleging any kind of fraud -- insurance fraud, because they have maintained until today that they are not claiming that; they are simply claiming that the number of policies is something that they don't like as far as the way the statute is written or interpreted.

And, I just want to make sure that we don't have any misconception now that there is any insurance fraud or criminal conduct alleged by the Government on the behalf of the Petitioner.

MR. KOHLHOFF: Your Honor, we are not taking a position that -- we are not taking any position as to fraud. We think the facts will speak for themselves. We are not trying to prove that Mr. Dodge participated in criminal conduct, but we think our witness will testify that these type schemes can involve criminal conduct.

And it is just a matter of --.

THE COURT: Okay. But, you are not going to ask your witness whether, in fact, has he examined Mr. Dodge's investments, and do they constitute criminal conduct.

MR. KOHLHOFF: Not as to criminal conduct, but we ultimately would like to bring an expert, ask that expert to review some of the documents that have been stipulated to, and give an ultimate opinion as to -- based on his experience investigating insurance speculation, is Mr. Dodge's conduct consistent with insurance speculation.

That is all we would ask.

MR. SAYRE: And, I have said that we object to that line of testimony, Your Honor. We said that in the pretrial memorandum, that, that -- as long as there is no criminal conduct, there is -- and no limitation whether he can buy 1,000 or 5,000 policies, that the repercussions of the tax law applicable to those, whether it is one or one-hundred, should be the same.

And, I don't see --.

THE COURT: The Government is not claiming that Mr. Dodge -- or, if they are, they are keeping it to themselves -- they

are not going to claim here in Court that he engaged in criminal conduct with regard to his purchases of these insurance contracts. That is what Mr. Kohlhoff said.

You wanted to know --.

MR. SAYRE: Right, which would defraud the insurance company.

THE COURT: That is what he has said, and I take him at his word.

MR. SAYRE: Okay.

THE COURT: He has also said that his witness is not going to be asked whether, in the opinion of the expert, Mr. Dodge's purchases constituted criminal activity here. So, does that satisfy you?

MR. SAYRE: Yes, Your Honor; with regard to that, that does.

THE COURT: Thank you.

MR. SAYRE: In the question of whatever this term insurance speculation -- and its aspect will have to be decided, I suppose, when that witness appears.

THE COURT: Well, the witness apparently is going to testify that insurance speculation may, in some circumstances, constitute criminal conduct.

But, he is not going to be asked to testify whether the insurance speculation that he has testified to, in his opinion, occurred in this case, whether that particular insurance speculation constituted criminal conduct or not.

MR. SAYRE: All right. Thank you.

THE COURT: *Okay. First witness, please.*

(Tr. 25–32)

APPENDIX E

Tables Summarizing Stipulated Evidence Of Categories And Dollar Amounts Of Petitioners' Deposits; Identification Of Source Of Deposits; Stipulated Net Income From Hobby Sales; And HIP Policies And Hospitalizations Of Charles A. Dodge

TABLE 1

Identification Of Deposited Amounts

Classification *	Year 1981 (JX 72-BJ)	Year 1982 (JX 73-BK)	Year 1983 (JX 74-BL)	Year 1984 (JX 75-BM)
Category 1 - Insurance Proceeds	$17,848.82	$31,823.13	$ 81,423.69	$126,271.17
Category 2 - Not Identified	20,707.83	2,768.16	56,755.61	13,151.23
Category 3 - Identified Miscellaneous	.00	15,784.97	22,229.69	114,076.71
Category 4 - Taxable Reported	126.39	751.56	1,552.13	1,229.43
Category 5 - Nontaxable	460.70	19,638.53	133,992.57	32,873.98
Total	$39,143.74	$70,766.35	$295,953.69	$287,602.52

* The Petitioners and the IRS stipulated in the Tax Court (from base information found in the indicated Stipulation Exhibits) that the amounts deposited to their various bank accounts during the period 1981–1984 could be grouped into the these five (5) general categories.

TABLE 2

Deposits To Petitioner's Bank Accounts, 1981–1984
(JX 72–BJ Through JX 75–BM)

Year	Total Amount Deposited To All Accounts	Amounts Remaining Not Identified	Percentage Of Total Still Not Identified
1981 *	$ 39,143.74	$20,707.83	52.9%
1982	70,784.35	2,768.16	3.9%
1983	297,212.31	44,730.15	15.0%
1984	292,384.02	13,151.23	4.5%
Total	$699,524.42	$81,357.37	11.6%

* The amount for 1981 does not include the Specialty Marketing bank account (JX 9–I) to which more than $34,600.00 was deposited in 1981, and which the IRS and the Petitioners stipulated (Stip. ¶73) resulted in the realization of no taxable income to the Petitioners.

TABLE 3

Additional Income Acknowledged By Petitioners As Amounts Not Previously Reported To IRS

Year	Additional Capital Gain	Net Amount From * Vehicle Sales	Net Amount From * Jewelry Sales
1981	$ .00	$ .00	$ .00
1982	.00	.00	1,200.00
1983	.00	2,000.00	6,300.00
1984	1,533.86	.00	1,800.00

* These amounts are to be divided 50% to each Taxpayer, per Judge Swift's Tax Court Opinion.

TABLE 4

HIP Policies Owned By Charles A. Dodge

Year	Number Of Policies	Issuing Companies *	Category 1 Insurance Proceeds
1981	33	26	$ 17,848.42
1982	26	33	31,823.13
1983	62	37	81,423.69
1984	48	26	126,271.17

* The parties have stipulated a summary of the HIP policies owned by Charles A. Dodge during each of these four years (JX 50-AX), and they have agreed upon the identified deposits for HIP benefits (JX 72-BJ through 75-BM, Category 1, Insurance Proceeds). The records on Mr. Dodge's HIP policies subpoenaed by the IRS were also stipulated to by the parties. (Stip. ¶s. 26 through 50, JX 25-Y through JX 49-AW).

TABLE 5

Summary Of Charles A. Dodge's Hospitalizations During 1981–1984

Dates Of Hospitalization	Hospital And Location	Reason For Hospitalization	Admitting Physician
03/16/81 – 04/06/81	Francis A. Bell Memorial Hospital, Ishpeming, Michigan	Slipped on ice while exiting car. Neck and back pain, allergic reaction to ear drops while in hospital.	Dr. W. G. Schroeder
05/25/82 – 06/18/82	Francis A. Bell Memorial Hospital, Ishpeming, Michigan	Hemorrhoidectomy, perforated bowel, peritonitis, and urinary blockage.	Dr. W. G. Schroeder
08/05/83 – 08/13/83	Baxter County General Hospital, Mountain Home, Arkansas, transferred on 08/06/83 to St. John's Regional Health Center, Springfield, Missouri	Fell down stairs at home, and suffered neck and back pain, and weakness in extremities	Dr. Bert E. Park, and Dr. William R. Truitt

08/19/83 – 09/02/83	Francis A. Bell Memorial Hospital, Ishpeming, Michigan	Headache, pain in neck and left arm, weakness, and residual numbness from fall, suspected subdural hematoma.	Dr. W. G. Schroeder
11/03/83 – 11/10/83	Francis A. Bell Memorial Hospital, Ishpeming, Michigan	Residual neck and back pain stemming from fall down stairs on 08/05/83.	Dr. W. G. Schroeder
04/27/84 – 05/11/84	Lakeside Community Hospital, Incline Village, Nevada, transferred on 05/07/84 to Washoe Medical Center Hospital, Reno, Nevada	Back pain injury suffered from strain while changing tire. Headaches, depression and anxiety as result of pneumoencephalogr am test at Washoe Medical Center.	Dr. W. D. Brodie, and Dr. J. P. Maloney at Lakeside, and Dr. Hale Henson, and Dr. Malcolm Bacchus at Washoe
08/24/84 – 09/02/84	Loma Linda Community Hospital, Loma Linda, California	Fell off lawn mower, and hurt back and legs, sought advice of orthopedic specialist	Dr. E. T. Dombrowski, and Dr. Kern H. Pihl

(2)
FILED
JUN 23 1993
OFFICE OF THE CLERK

No. 92-1697

In the Supreme Court of the United States

OCTOBER TERM, 1992

CHARLES A. DODGE AND CHRISTINE Y. ROBERTS,
PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTIONS PRESENTED

1. Whether the "bank deposits method" of reconstructing petitioners' income may be used when petitioners (i) had over $700,000 in deposits, (ii) produced no financial records to account for those deposits, and (iii) filed no returns, or returns reporting only minimal income, during the four-year period at issue.

2. Whether certain hospital indemnification insurance proceeds received by petitioner Dodge did not relate to actual, legitimate injuries or sickness, and were therefore not excludable from income under Section 104(a)(3) of the Internal Revenue Code, 26 U.S.C. 104(a)(3).

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CHARLES A. DODGE AND CHRISTINE Y. ROBERTS,
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v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-13a) is reported at 981 F.2d 350 (8th Cir. 1992). The opinion of the Tax Court (Pet. App. 14a-31a) is reported at 96 T.C. 172 (1991).

JURISDICTION

The judgment of the court of appeals was entered on December 9, 1992. A petition for rehearing was denied on January 20, 1993. The petition for a writ of certiorari was filed on April 20, 1993. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Petitioners Dodge and Roberts, who are not married, began living together in 1980 (Pet. App. 18a) and have commingled their finances since 1981 (Pet. App. 2a). During the years 1981 through 1984, petitioners received profits from sales of automobiles and jewelry (*ibid.*). In addition, Dodge received substantial amounts in insurance proceeds under 30 to 60 "hospital indemnification" insurance policies ("HIPs") that he carried during that time (Pet. App. 18a-21a).[1] During the years relevant here, Dodge was hospitalized seven times, primarily as a result of falls he purportedly suffered, although on one occasion he was hospitalized for a hemorrhoidectomy (Pet. App. 22a-23a). The physician who admitted him to the hospital on four occasions, Dr. Schroeder, was a personal friend to whom Dodge had lent $50,000 (Pet. App. 23a). During 1981 through 1984, Dodge's HIP policies paid him benefits of more than $257,000, while he incurred actual hospital expenses of only $29,445 (Pet. App. 24a).

2. Dodge filed no income tax returns for 1981 through 1984.[2] Roberts's returns for these years

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[1] A HIP policy typically pays an insured a fixed amount ($25 to $100) for each day he is hospitalized, regardless of his actual hospital expenses or his other insurance coverage. HIPs are subject to exploitation by "insurance speculators" who buy multiple policies and then arrange with "friendly" doctors to be hospitalized for extended periods after purported "slip-and-fall" accidents (Pet. App. 21a).

[2] Dodge was convicted in 1976 of criminal violations of the tax laws. He has a history of failing to file tax returns. *United States* v. *Buttorff*, 572 F.2d 619, 622 (8th Cir.), cert. denied, 437 U.S. 906 (1978). In another case, the Tax Court found him

reported only small amounts of income, none of which came from the sale of jewelry or cars or from any business source (Pet. App. 2a, 25a, 30a-31a).[3] On audit, the IRS undertook to reconstruct petitioners' earnings by analyzing deposit slips from the banks at which they maintained accounts (Pet. App. 25a). The Commissioner found it necessary to use the "bank deposits" method because petitioners furnished no books and records to the revenue agent (*ibid.*).[4] On the basis of a reconstruction of petitioners' income, the Commissioner determined deficiencies in income tax for each of petitioners for 1981 through 1984, together with additions to tax for negligence and for substantial understatements of tax (Pet. App. 15a-16a). Petitioners filed a joint petition to the Tax Court for review of the deficiencies.

3. In the Tax Court, the parties stipulated that nearly $700,000 had been deposited into petitioners' bank accounts during the years at issue and that the deposits were divisible into five categories: (1) HIP "insurance proceeds" of approximately $257,000; (2)

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liable for income tax deficiencies and additions to tax for 1973 through 1975 as a result of unreported income derived in part from tax protester activities. *Dodge* v. *Commissioner*, 46 T.C.M. (CCH) 842, 845 (1983).

[3] Petitioners' assertion (Pet. 16 n.11) that Roberts "has complied with all statutory requirements regarding * * * the reporting of gross income" is thus plainly wrong. As noted by the Tax Court, Roberts "failed to report income that a reasonable person would have reported under the circumstances, namely proceeds from the sale of automobiles and jeweiry" (Pet. App. 30a-31a).

[4] The Tax Court stated that petitioners' records were apparently destroyed by a fire at their home in January of 1984 (Pet. App. 25a-26a).

"not identified" amounts of approximately $93,000; (3) "identified-miscellaneous" amounts of approximately $152,000; (4) "taxable reported" income of $3,658; and (5) "non-taxable" receipts of $187,000 (Pet. App. 26a). The Commissioner regarded the proceeds of Dodge's HIP insurance as taxable. Petitioners contended, however, that the proceeds were excludable from Dodge's gross income under Section 104(a)(3) of the Internal Revenue Code, which excludes from income "amounts received through accident or health insurance for personal injuries or sickness" (26 U.S.C. 104(a)(3)).

4. The Tax Court upheld the Commissioner's determinations. The court found that the HIP insurance proceeds did not qualify for the Section 104(a)(3) exclusion because the statute confines the exclusion to amounts paid "for personal injuries or sickness" (Pet. App. 27a). After expressing doubts as to petitioners' and Dr. Schroeder's credibility, the court found that petitioners failed to establish that Dodge's numerous hospital admissions resulted from actual injuries or sickness, rather than being contrived as part of an insurance speculation scheme (*ibid.*). The court therefore ruled that the insurance proceeds were includable in Dodge's income.

The court also found that petitioners failed to show that the deposits in the "unidentified" and "miscellaneous" categories derived from a nontaxable origin (Pet. App. 28a-29a). The court found that a portion of these deposits was attributable to petitioners' sales of automobiles and jewelry, and the court thus included one-half of such portion in the income of each petitioner (Pet. App. 29a). Most of the remaining amounts were taxed to Dodge (*ibid.*). Finally, the

court sustained the additions to tax for negligence and substantial understatements of tax (Pet. App. 30a-31a).

5. The court of appeals affirmed in part and reversed in part the Tax Court's decision. The court rejected petitioners' argument that the Commissioner bore the burden of proof in this case because the IRS had made a "naked" assessment. The court concluded that "[w]e do not find the Commissioner's use of the indirect bank deposits method, under the circumstances, to be anything less than reasonable and rationally based" (Pet. App. 4a-5a).

The court also upheld—as to six of the seven hospital stays in question—the Tax Court's finding that Dodge's HIP insurance proceeds were not excludable under Section 104(a)(3) because the proceeds had not been received for actual personal injury or sickness (Pet. App. 8a). The court reversed the Tax Court's finding with respect to amounts received in connection with Dodge's seventh hospital stay (for a hemorrhoidectomy), finding that such amounts had in fact been received for a genuine personal injury or sickness (Pet. App. 10a-11a).[5]

The court also generally upheld the Tax Court's finding that petitioners failed to meet their burden of proving that the other deposits at issue were from nontaxable sources (Pet. App. 12a). The court, however, reversed the Tax Court's finding with respect to one $50,000 payment petitioners received, for evidence

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[5] The court rejected petitioners' argument that the Commissioner's contention that the HIP proceeds did not qualify for the Section 104(a)(3) exclusion was a "new matter" on which the Commissioner bore the burden of proof (Pet. App. 7a).

indicated that this amount was in repayment of a loan (Pet. App. 11a-12a).

ARGUMENT

The decision of the court of appeals in this fact-bound case is correct and does not conflict with any decision of this Court or of any other court of appeals. Further review is therefore not warranted.

1. a. In tax litigation, the Commissioner's determination of a deficiency is presumed to be correct, and the taxpayer bears "the burden of proving it to be wrong." *Welch* v. *Helvering*, 290 U.S. 111, 115 (1933); United States Tax Court Rule 142. An exception to that general rule exists for "naked" assessments made without *any* foundation. In that situation, the Commissioner's determination is said to be "arbitrary" and is therefore not entitled to the benefit of the presumption of correctness. See *United States* v. *Janis*, 428 U.S. 433, 441-442 (1976); *Weimerskirch* v. *Commissioner*, 596 F.2d 358 (9th Cir. 1979).

Petitioners err in contending (Pet. 18-21) that the Commissioner's determinations in this case lack any factual foundation and are therefore not entitled to the presumption of correctness. When a taxpayer receives substantial amounts of cash or other liquid assets and is unable or unwilling to provide the necessary records to explain his acquisition of those assets, the Commissioner's deficiency determination based upon the taxpayer's receipts is not a "naked assessment" but is one that is entitled to the normal presumption of correctness.

The decision by the Ninth Circuit in *Delaney* v. *Commissioner*, 743 F.2d 670 (1984), is illustrative. In *Delaney*, the taxpayers did not dispute that they had

brought into the country over $40,000 in gold coins during the two-year period at issue. The taxpayers also gave incomplete or unsatisfactory answers to IRS inquiries concerning their acquisition of the coins. The taxpayers nevertheless contended that the burden of proof was on the Commissioner to establish that the coins were traceable to unreported income.

The Ninth Circuit, in an opinion by then-Judge Kennedy, rejected the taxpayers' contention. The court pointed out that the taxpayers conceded that they had brought the coins into the country and had given incomplete and unsatisfactory explanations about the coins to the IRS. The court held that, in these circumstances, the usual presumption of correctness applies. *Id.* at 672. See also *Erickson* v. *Commissioner*, 937 F.2d 1548, 1551-1552 (10th Cir. 1991) ("Once the Commissioner demonstrate[s] sufficient minimal facts to show an ownership interest in assets possessed by the taxpayers, the presumption of correctness remain[s] with the notice of deficiency and the taxpayers [have] the burden of satisfactorily explaining how they came to possess the liquid assets, and to show why the assets did not represent taxable income in the year in question"); *Schad* v. *Commissioner*, 87 T.C. 609, 618-620 (1986) ("connecting [the taxpayer] to the funds that form the basis of the deficiency is sufficient to give him the burden of proving the deficiency determination erroneous"), aff'd, 827 F.2d 774 (11th Cir. 1987) (Table).

The principle of these decisions applies to this case. Petitioners did not dispute that they had made more than $700,000 in bank deposits during the years at issue. They produced no financial records relating to those deposits. They either filed no returns for the

years at issue or filed returns reporting minimal income. Moreover, evidence pointing to the existence of an insurance speculation scheme was present. Under these circumstances, the Commissioner had "little choice" (Pet. App. 4a) but to use the bank deposits method to reconstruct petitioners' income. See also *Anaya* v. *Commissioner*, 983 F.2d 186, 188 (10th Cir. 1993) ("If the taxpayer fails to keep adequate records, the Commissioner is entitled to use any reasonable means to reconstruct the taxpayer's income"); *DiLeo* v. *Commissioner*, 96 T.C. 858, 867 (1991) ("When a taxpayer keeps no books or records and has large bank deposits, the Commissioner is not arbitrary or capricious in resorting to the bank deposits method for computing income"), aff'd on other grounds, 959 F.2d 16 (2d Cir.), cert. denied, 113 S. Ct. 197 (1992). The deficiency determination based on that method was entitled to the presumption of correctness.[6]

Petitioners err in asserting (Pet. 16, 19) that the decision in this case conflicts with the decision in *Armes* v. *Commissioner*, 448 F.2d 972 (5th Cir. 1971).[7]

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[6] Petitioners appear to contend (Pet. 16, 18-21) that even if the Commissioner's determination was not "arbitrary and capricious" as to petitioner Dodge, it was so as to petitioner Roberts. Due to the commingling of petitioners' funds and their inability to produce records, the Commissioner acted reasonably in determining that the deposits were income to both parties. As noted by the court below, on the facts of this case it would have been "irrational, and also unfair, to arbitrarily assign the joint funds to either Dodge or Roberts" (Pet. App. 5a).

[7] The asserted intra-circuit "conflict" (Pet. 21) between the Eighth Circuit's decision in this case and its prior decision in

In *Armes*, the court held that the Commissioner failed to meet his burden of showing a "likely taxable source" for bank deposits. *Id.* at 975. The evidence in this case meets that standard, for it reflects that petitioners had unreported income from insurance payments and from the sale of jewelry and automobiles. This evidence included copies of financial statements that petitioners submitted to a bank in 1982 and 1983, in which they represented that they were in the business of marketing diamonds and autos, and that their estimated income from their business during those years was between $65,000 and $100,000 (C.A. App. 1342, 1343).

Contrary to petitioners' contention (Pet. 16, 19), the decision in this case also does not conflict with either *United States* v. *Morse*, 491 F.2d 149 (1st Cir. 1974), or *Portillo* v. *Commissioner*, 932 F.2d 1128 (5th Cir. 1991). *Morse* involved a criminal tax prosecution and has no relevance to the burden of proof in civil tax litigation. In *Portillo*, the court held that the Commissioner was not entitled to a presumption of correctness because he did not present "some predicate evidence supporting [his] determination." 932 F.2d at 1133. Such substantiation, according to the court, could include "showing the taxpayer's net worth, bank deposits, cash expenditures, or source and application of funds." 932 F.2d at 1134. In the instant case, of course, it was undisputed that petitioners had made over $700,000 in bank deposits during the years at issue.

Kirsch v. *United States*, 174 F.2d 595 (1949), does not warrant review by this Court.

b. Petitioners also err in asserting (Pet. 28-30) that their ability to identify a non-taxable source for a portion of the deposits prior to trial shifted the burden of proof to the Commissioner as to the tax status of the remaining unexplained deposits. Petitioners' ability to rebut the presumption of correctness as to several items of a multiple assessment does not affect the presumed correctness of the rest of the assessment or alter the burden of proof. *United States* v. *Stonehill*, 702 F.2d 1288, 1294 (9th Cir. 1983), cert. denied, 465 U.S. 1079 (1984); *Zeeman* v. *United States*, 395 F.2d 861, 866-867 (2d Cir. 1968). It "is especially appropriate" for petitioners to retain the burden of proof "in cases, such as this, where the Commissioner and tax court have classified a large portion of the belatedly identified deposits as taxable income" (Pet. App. 6a).

2. Section 104(a)(3) of the Internal Revenue Code excludes from a taxpayer's gross income "amounts received through accident or health insurance for personal injuries or sickness." 26 U.S.C. 104(a)(3). As the language of Section 104 demonstrates, the statutory exclusion presupposes the existence of an actual personal injury or sickness. It is not made applicable merely because there are hospitalizations or the receipt of insurance benefits. The courts below correctly found (Pet. App. 8a, 27a) that the majority of Dodge's hospital admissions did not relate to actual injuries or sickness, but were instead contrived as part of his insurance speculation scheme. The nature of Dodge's alleged injuries, the close relationship between Dodge and the admitting physicians, and the lack of credible testimony from petitioners provide ample support for the lower courts' finding that (with

the single exception noted by the court of appeals) the HIP proceeds were received in connection with Dodge's insurance "program" rather than for personal injuries. This factual finding, concurred in by both courts below, does not warrant further review. *Tiffany Fine Arts, Inc.* v. *United States*, 469 U.S. 310, 317-318 n.5 (1985).[8]

Petitioners err in contending (Pet. 17, 25) that the decision in this case conflicts with this Court's decisions in *Commissioner* v. *Heininger*, 320 U.S. 467 (1943); *Lilly* v. *Commissioner*, 343 U.S. 90 (1952); *Commissioner* v. *Sullivan*, 356 U.S. 27 (1958); *Tank*

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[8] There is also no merit to petitioners' assertion (Pet. 21-22) that the Commissioner's contention that the HIP proceeds did not qualify for the Section 104(a)(3) exclusion was a "new matter" on which the Commissioner bore the burden of proof. A "new matter" is a theory or allegation, pleaded by the Commissioner in his answer, that alters (rather than refines) the determination of the Commissioner in the notice of deficiency. *Abatti* v. *Commissioner*, 644 F.2d 1385, 1390 (9th Cir. 1981); United States Tax Court Rule 142(a). In the notice of deficiency, the Commissioner explained his determination that Dodge had received taxable income during the years at issue by stating generally that "[i]n the absence of adequate records, your taxable gross receipts have been computed on the basis of bank statements" (C.A. App. 477). Petitioners themselves raised the Section 104(a)(3) issue in their Tax Court petition by alleging that "any amounts [Dodge] received * * * were non-taxable insurance proceeds" (C.A. App. 8). The Commissioner denied petitioners' allegation that Dodge's receipts were nontaxable insurance proceeds (C.A. App. 13). The Commissioner's denial of Dodge's nontaxable-insurance-proceeds allegation in his answer was a further refinement of the original determination that Dodge had received taxable income. It did not alter that determination and did not represent a "new matter."

Truck Rentals, Inc. v. *Commissioner*, 356 U.S. 30 (1958); and *Hoover Motor Express Co.* v. *United States*, 356 U.S. 38 (1958). According to petitioners, these cases stand for the proposition that statutory deductions may not be denied unless their allowance would frustrate a "sharply defined" public policy (Pet. 25). Petitioners were not denied the exclusion from income provided by Section 104 on public policy grounds. Instead, as the opinions below make clear (Pet. App. 7a-8a, 27a), the Section 104 exclusion was denied because the insurance payments did not fall within the terms of the statute, which require that the amounts be received "for personal injuries or sickness" (26 U.S.C. 104(a)(3)). The cases on which petitioners seek to rely are simply not on point.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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REPLY BRIEF FOR PETITIONERS

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QUESTIONS PRESENTED

1. Have this Court's previously mandated procedural guidelines for the use and application of the burden of proof and presumption of correctness standards in Tax Court controversies been so abused by the IRS, and misapplied by the inferior federal courts, in this case, that this Court should use this case as a vehicle for further defining the IRS's proper use of the bank deposits method of determining a taxpayer's gross income, especially where the IRS's arbitrary actions have resulted in a "naked assessment" against Petitioner Roberts?

2. In a case of first impression in the interpretation of the federal tax law, did the lower courts err in partially upholding the IRS's denial of Petitioner Dodge's claim to the exclusionary tax benefits provided by Congress for the recipients of HIP insurance benefits, under 26 U.S.C. § 104(a)(3), where there is no sharply defined public policy that is being served by denying the taxpayer such benefits, and the burden of proof was erroneously placed upon Petitioner Dodge on this issue (even though the IRS's "litigating position" on this HIP benefit issue was a *new* issue, raised by the IRS only shortly before trial in the Tax Court)?

3. Though the circuit court found that the Petitioners had partially met the burden of proof placed upon them in this bank deposits reconstruction case, and therefore that court overturned several key factual findings of the Tax Court, as being clearly erroneous; did the circuit court err in failing to hold that the burden of proof shifted to the IRS to offer evidence of likely taxable sources for the remaining disputed deposits, when the Petitioners had identified nearly 90% of the deposits, the vast majority came from nontaxable sources, and the auditing revenue agent testified that he knew of only one taxable source for a small amount of the questioned deposits?

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APPENDIX F:

A. Portion of the Chief Counsel's Manual (Department of the Treasury, Internal Revenue Service) 1a

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REPLY BRIEF FOR PETITIONERS

In reply to the allegations and assertions contained in the Brief in Opposition filed in this case by the Solicitor General and personnel of the Tax Division of the Department of Justice, on behalf of the IRS, the Petitioners file this Reply Brief to address and to refute certain erroneous representations and innuendos left by the government's arguments, and especially to bring to the attention of the members of this Court the fact that the *new* litigating position adopted and asserted by the IRS in this case (with regard to the HIP insurance proceeds received by Petitioner Dodge in each of the four years in question) is a litigating position that clearly violates the standards established in the IRS's Chief Counsel's Manual (App. F, *infra*, p.1a). Such *new* litigating position is diametrically opposed to the published position taken in several of the IRS's published rulings, in violation of even the IRS's own "in-house" standards. [1] See Treasury Regulation on Income Tax §1.104-1(d); Rev. Rul. 58-602, 1958-2 Cum. Bull. 109; and Rev. Rul. 69-154, 1969-1 Cum. Bull. 146 (Pet. 22, ftnt. 13). This Reply Brief will be devoted strictly to a discussion of these matters raised in the IRS's Brief in Opposition.

1. **Government's Unsanctioned Litigating Position.** After the Petition for Certiorari was filed in this case, the undersigned counsel for the Petitioners first become aware of the existence of a Chief Counsel's Manual for the IRS, which Manual apparently contains rules and standards that must be followed by personnel of the various District Counsel's Offices in adopting litigating positions in all tax cases. In response to a written inquiry to the Office of the Chief Counsel of the IRS in Washington D.C., counsel for the Petitioners has been supplied with a portion of this Chief Counsel's Manual, which provides, in part, that the IRS will

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[1] Even the existence of a Chief Counsel's Manual for the IRS, and the particular provisions set forth in Appendix F, *infra*, 1a, were not known to the undersigned counsel for the Petitioners, until after the Joint Petition for Certiorari was filed with this Court in this proceeding. The Chief Counsel's Manual is *not* readily available to members of the bar or to the general public; it is not available at any IRS office in Arkansas; and it may be available here in Arkansas only on certain electronic legal research services.

not take a litigating position in court in a tax case that is contrary to a published IRS ruling. Particularly, ¶ (35)8(12)3(6) of this Manual (App. F, *infra*, 2a) provides in part --

> The position taken in all cases, whether in the field offices or in the National Office, must be in accord with the technical and litigating position of the Chief Counsel. *The Service position, as a general rule, is initially determined in the regulations and published rulings, and it is the role of the Litigation Division of the office to support such positions.* (Emphasis supplied)

Thus, it is the understanding of the counsel for the Petitioners that the IRS will *not* assert a litigating position in a Tax Court case that is contrary to a published position that the IRS has taken in one of its rulings. As noted in the Petitioners' Petition for Certiorari (22-24), the *new* litigating position taken by the IRS against Petitioner Dodge (i.e. the HIP insurance proceeds he received in these years do not qualify for the *exclusion from gross income* provided by 26 U.S.C. § 104(a)(3)) is not only a *new* litigating position (that was taken substantially after the Respondent's Answer was filed in this proceeding); it is one that is diametrically opposed to these published standards of the Chief Counsel's Office, especially since these are published revenue rulings of longstanding that are directly on point and are contrary to the IRS's *new* litigating position asserted here.

Though some five months have now passed since the Petition for Certiorari was filed in this case; and some five years have now passed since the IRS first asserted this *new* litigating position in this case; the IRS has *not* withdrawn or modified its published rulings of longstanding regarding the tax free treatment of amounts received from HIP insurance proceeds that are in *excess* of actual medical expenses incurred. Accordingly, for the additional reason that the government is asserting a litigating position in this case against Petitioner Dodge that is diametrically opposed to the taxing agency's published interpretative policy of longstanding; and such interpretive position has been asserted *only* against Petitioner

Dodge in this case (without such litigating position having been asserted in any other reported case, or published IRS ruling or regulation); the Court should grant the Petitioners' Petition for Certiorari and reverse this unfair and inequitable assertion of an unsanctioned litigating position by the IRS against one of the Petitioners in this case, when that position has *not* been asserted against any other taxpayer in the country.

2. ***New* Litigating Position.** The IRS asserts in its Brief in Opposition (Br. Opp. 10–12) that this Court's prior decisions [2] -- where it was held that deductions or exclusions provided by statute should not be denied, unless a "sharply defined" public policy is present -- are inapplicable here, is, at the very least, an erroneous statement of the IRS's initial litigating position in this case. Such assertion could possibly even be described as a deliberate attempt to simply "cover up" the litigating position asserted by the IRS only shortly before the trial was originally scheduled in this case. Before this Court, the present counsel for the IRS [3] erroneously argues (Br. Opp. 11, ftnt. 8) that the

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[2] *Commissioner v. Heininger*, 320 U.S. 467 (1943); *Lily v. Commissioner*, 343 U.S. 90 (1952); *Commissioner v. Sullivan*, 356 U.S. 27 (1958); *Tank Truck Rentals, Inc. v. Commissioner*, 356 U.S. 30 (1958); and *Hoover Motor Express Co. v. United States*, 356 U.S. 38 (1958).

[3] Before the Eighth Circuit, and in this Court, the IRS has been represented by attorneys of the Appellate Division of the Tax Division of the Department of Justice. In the Tax Court proceeding, the IRS was represented by attorneys of the Office of the District Counsel in Nashville, Tennessee. The *new* litigating position asserted by the IRS on September 8, 1988, regarding the agency's interpretation of 26 U.S.C. § 104(a)(3), was asserted as a matter of "public policy" by the IRS's counsel. *All* of the cases cited in footnote 2, *supra*, were cited and argued by the IRS's own counsel as being applicable to this *new* litigating position on the HIP insurance proceeds issue. The burden of proof and presumption of correctness standards (relied on by the government's counsel in this Court) were *not* argued at all by the IRS's counsel before the Tax Court, as these standards might apply to the HIP insurance proceeds issue. See, Brief for Respondent and Reply Brief for Respondent filed in *Dodge and Roberts v. Commissioner*, Docket No. 9830–87, that were filed with the Clerk of the United States Tax Court. It was *only* after Judge Swift's Opinion in the Tax Court was rendered on a "burden

assertion of the *new* litigating position by the IRS with regard to 26 U.S.C. §104(a)(3) was *not* raised as a "new matter" (as that term is used in Rule 142(a) of the Rules of the United States Tax Court), but, instead, was a mere *refinement* of the IRS's original position. In fact, the IRS's present counsel even attempts to assert that this litigating position was first raised by the Petitioners in their Tax Court Petition. Such assertions by the government do *not* correctly reflect the status of the record in this case.

The auditing Revenue Agent testified that he merely added up all the deposits to the Petitioners' joint and separate bank accounts; he asserted that *all* such deposits were income to *both* Petitioners: and he inconsistently proposed huge proposed deficiencies in income taxes and penalties against both Petitioners, based upon the same deposited items. Therefore, *any* legal or litigating position taken by the IRS on the tax treatment of the HIP insurance proceeds received by Petitioner Dodge would have to be considered a *refinement* of the government's position under the IRS's theory in this case. This is because the initial litigating position taken by the IRS was *so broad* that the IRS actually took no specific position at all on these HIP insurance proceeds (or any other of the Petitioners' deposits). Though the Petitioners generally asserted in their Petition that their bank deposits came from

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of proof" and "presumption of correctness" standard with regard to the HIP proceeds issue that the attorneys of the Appellate Section of the Tax Division of the Department of Justice abandoned the "public policy" arguments initially asserted by the IRS in support of its *new* litigating position, and the present legal position was adopted by the government's counsel, based solely upon the "burden of proof" and "presumption of correctness" standards that the government has asserted before the Eighth Circuit and before this Court. The Petitioners submit that the federal taxing agency has an obligation, especially in this case, to stand by its asserted litigating position that caused in this litigation in the first place, as opposed to adopting an *expedient* legal position (based upon burden of proof and presumption of correctness standards) in an attempt to uphold the Tax Court's decision, which opinion did not address the IRS's *new* litigating position on this HIP insurance proceeds issue. In this regard, the Petitioners submit that the IRS has a higher duty than normal litigants in adopting and maintaining its litigating positions, because such litigating positions should be applied to *all* taxpayers alike, not just to these Petitioners.

numerous nontaxable sources, including excluded insurance proceeds, the IRS did *not* assert the specific litigating position it adopted in this case (before the Tax Court and in its Tax Court briefs) in its Answer. Instead, the IRS simply alleged a general denial. It was not until September 8, 1988, when the IRS's counsel wrote to the Petitioners' counsel (more than 20 months after the IRS issued the Statutory Notice of Deficiency in this case) that this *new* litigating position was first asserted by the IRS in this case.

Under such circumstances, the assertion of this litigating position by the IRS raised a "new matter," as those terms are used in Rule 142(a) of the Rules of the United States Tax Court. It is *not* necessary for a litigating position to be raised *only* in the IRS's pleadings before it can be considered a "new matter." See, *Baird v. Commissioner*, 438 F.2d 490 (C.A.3, 1970); *Weinerskirch v. Commissioner*, 596 F.2d 358 (C.A.9, 1979); *Estate of Falese v. Commissioner*, 58 T.C. 895, 898–99 (1972); *Fitzpatrick v. Commissioner*, 37 T.C.M. 159, CCH T.C. Memo. 1978–27; *Florists' Transworld Delivery Assn. v. Commissioner*, 67 T.C. 333, 347–48 (1976); *Suarez v. Commissioner*, 61 T.C. 841 (1974); *Denman v. Commissioner*, 42 T.C.M. 249, CCH T.C. Memo. 1981–332; and *Zarin v. Commissioner*, 92 T.C. 1084, 1088–89 (1989).

Thus, the Petitioners assert that the "burden of proof" on the HIP insurance proceeds issue should have been properly placed upon the IRS by the Tax Court, as a "new matter" raised by the IRS; that the IRS's failure to produce *any* evidence to support its *new* litigating position on the HIP insurance proceeds issue is a fatal flaw in the government's case; and that this Court should grant the Petitioners' Petition for Certiorari and use this case as a vehicle for delineating a more "bright line" or "clear cut" standard with regard to the proper placement of the "burden of proof" on "new matters" raised by the IRS in Tax Court litigation, after the taxing agency's position has been asserted in its pleadings,[4] so that

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[4] The Petitioners assert that, since this is an action to assess a tax, not an action where the taxpayers are seeking a refund, the proper application of the "burden of proof" standards here will cause the proposed assessment to fail in this case, in its entirety, because the IRS has failed to offer *any* evidence in support

both the IRS and taxpayers will have a clearer view of where the burden of proof lies on an issue *not* raised by the IRS in its Notice or pleadings, but which is belatedly asserted at trial.

3. **Distorted Presentation of Controlling Facts.** The IRS has erroneously alleged (Br. Opp. 6–9) that the evidentiary record in this case establishes that the Service properly applied the bank deposits (indirect) method of reconstructing the Petitioners' income; that the usual "burden of proof" and "presumption of correctness" standards are applicable to this case (and, therefore, that the "naked assessment" exception is *not* applicable here); and that this case does not warrant review by the Court because it has been decided on a factual basis, so that there is no conflict with the Fifth Circuit decisions in *Portillo v. Commissioner*, 932 F.2d 1128 (C.A.5, 1991) and *Armes v. Commissioner*, 448 F.2d 972 (C.A.5, 1971). The Petitioners assert that the IRS's reliance, in its Brief in Opposition, upon a very, very, general discussion of the controlling facts; its erroneous assertion that the taxpayers produced no records relating to the nearly $700,000.00 deposited to their bank accounts during the four years in question; and that the Petitioners filed no tax return or returns reporting "minimal income;" together with the assertion that the IRS was aware that an "insurance speculation" scheme was present, are positions that are not well taken and are asserted only to support the IRS's claims of the applicability of the normal presumption of correctness standards in this case. The Petitioners submit that such assertions are not only erroneous; such broad and general allegations are asserted (after the fact) by the IRS in an effort to "bootstrap" the taxing agency into a position of legitimacy; when, in reality, the detailed and voluminous facts of this case clearly establish that the IRS abused its assessment power and has, therefore, made the Petitioners (especially Ms. Roberts) "victims of the system" for the following reasons:

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of its *new* litigating position. See, *Helvering v. Taylor*, 293 U.S. 507 (1935); *Commissioner v. Riss*, 374 F.2d 161 (C.A.8, 1967) and *Ehler v. Vinal*, 382 F.2d 58, 65–66 (C.A.8, 1967). Therefore, the proposed deficiency against Petitioner Dodge that is based upon this HIP insurance proceeds issue should be abated, in its entirety.

a. **Bank Deposits Method Improperly Used.** Though it is unquestioned by Petitioners that there was nearly $700,000.00 deposited to their joint and separate bank accounts in the four year period of time involved in this case, they assert that the IRS did *not* properly apply the bank deposits (indirect) method of proof, because the Revenue Agent totally failed to establish the three requirements that the courts have mandated for the IRS's use of such indirect method of reconstructing a taxpayer's income. See, *Gleckman v. United States*, 80 F.2d 349 (C.A.8, 1935), *cert. denied*, 297 U.S. 709 (1936), and the arguments previously asserted by the Petitioners (Pet. 20–21). Though there was nearly $700,000.00 deposited into these bank accounts in these four years, Revenue Agent Westbrook testified that his examination had disclosed that the *only* taxable source for any of these deposits was the "net profit" realized from the Petitioners' sporadic sales of autos and jewelry. As reflected in Appendix E, Table 3 (Pet.), there was *no* income from these sources for the Petitioners in 1981; only $1,200.00 in 1982; $8,300.00 in 1983; and $1,800.00 in 1984. [5] Thus, the "net profits" from these sources for *all* four tax years represents only 1.6% of the total of $700,000.00 in deposits. Such minute amount cannot be relied upon by the IRS as a basis for asserting that the Revenue Agent's actions were proper with regard to the remaining 98.4% of these deposits.

The IRS stipulated that more than $190,000.00 in questioned deposits came from nontaxable sources or from sources that had already been reported by Ms. Roberts. (Categories 4 and 5, App. E, Table 1, Pet. 40a), and that such deposits were from *nontaxable* sources (such as bank transfers, loan repayments, etc.). The stipulated Category 1, Insurance Proceeds, contained more than $257,000.00 of identified deposits (with many of the Unidentified Deposits in Category 2 alone probably being from this same

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[5] In accordance with Judge Swift's Opinion in the Tax Court, 50% of these amounts each year were attributable to each of the Petitioners. There were no amounts deducted from these "net profits" for expenses and costs incurred by the Petitioners for normally deductible expense they incurred in realizing such "net profits," and, in fact, they referred to these sporadic sales activities as a "hobby."

source). The IRS's assertion that these HIP insurance proceeds represented a "taxable source" was *not* asserted by Revenue Agent Westbrook or the IRS when the Statutory Notices of Deficiency were issued to the Petitioners, or when the Respondents' Answer was filed in the Tax Court. Instead, the IRS did not even assert that the $257,000.00 in HIP insurance proceeds (which amounts were identified by the Petitioners and personnel of the Appellate Division of the IRS in pretrial review, while this matter was before the Tax Court), were a "taxable source," until September 8, 1988, when the IRS first asserted its *new* litigating position with regard to § 104(a)(3). Thus, the IRS must not be allowed to "pull itself up by its own petard" and attempt to "bootstrap" itself into a position where it can claim a legitimate use of the bank deposits method of reconstructing income.

b. Burden of Proof Shifted. The opinions of the Tax Court and the Eighth Circuit in this case have eliminated substantially more than another $100,000.00 in Category 3, Miscellaneous – Identified, from the amounts that the IRS originally asserted were taxable income of the Petitioners. The evidence in this case establishes that the vast bulk of the $93,000.00 in Category 2 – Unidentified, was probably deposits attributable to the Boatman's Bank account where most of the HIP insurance proceeds were first deposited. Thus, if the HIP insurance proceeds are held to be *excluded* from income (as claimed by the Petitioners), pursuant to the provisions of 26 U.S.C. § 104(a)(3), then there remain only a few thousand dollars in Unidentified or Miscellaneous Identified deposits in Categories 2 and 3 that would still be in dispute between the parties.

The inconsistent treatment by the IRS, the Tax Court and the Eighth Circuit of the amounts in Categories 2 and 3 that were deposited into the one separate bank account maintained by Petitioner Roberts (when *all* other such Category 2 and 3 deposits were attributable to Petitioner Dodge by the lower courts) places Petitioner Roberts in the untenable position of having more than $30,000.00 worth of taxable income attributed to her by the application of the normal "burden of proof" and "presumption of correctness" standards applicable to tax cases, without the IRS ever

having reviewed her individual records; and there is no showing that Ms. Roberts possibly had income in these amounts from her taxable sources. It is also undisputed that Ms. Roberts reported *all* of her taxable income in each year (though it may have been *minimal*) on her timely filed income tax returns (which returns all reflected *no tax due*). Therefore, Petitioner Roberts pleads with the members of this Court to hold that she should *not* be treated so oppressively by the "system," when she has attempted in every way to comply with the tax reporting requirements of the Internal Revenue Code, without the IRS being required to assume the burden of proof on these issues, not just rely upon the normal "presumption of correctness" to sustain even the last 5% of its proposed assessment against her.

Petitioners submit that the IRS's citation to the Ninth Circuit's decisions in *United States v. Stonehill*, 702 F.2d 1288 (C.A.9, 1983), *cert. denied*, 465 U.S. 1079 (1984) and *Delaney v. Commissioner*, 743 F.2d 630 (C.A.9, 1984); the Tenth Circuit's decision in *Erickson v. Commissioner*, 937 F.2d 1548 (C.A.10, 1991); and the Second Circuit's decision in *Zeeman v. United States*, 395 F.2d 861 (C.A.2, 1968), are not well taken, since those cases are clearly distinguishable on their faces from the facts established by the Petitioners in this case. The decision of the two courts below in this case are inconsistent with, and in conflict with, this Court's guidelines for the proper application of the burden of proof and presumption of correctness standards, [6] and they are clearly in conflict with the decisions of the Fifth Circuit in *Portillo*, *supra*, and *Armes*, *supra*. The IRS must not be allowed to abuse the vast powers granted to it by Congress in the statutory scheme created for the tax assessment system without having some obligation to offer direct proof to sustain its arbitrary determinations in this type of case.

Therefore, this Court should grant the Petition for Certiorari and hold that, in these types of circumstances, the burden of

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[6] See, *Helvering v. Taylor*, 293 U.S. 507 (1935) and *United States v. Janis*, 482 U.S. 433 (1976).

proof shifts to the IRS when the taxpayers have offered credible evidence to support their position, and that the IRS rests, at its peril, *only* when it relied upon the "presumption of correctness" usually accorded its determinations to sustain its proposed assessment.

CONCLUSION

For the additional reasons set forth in this Reply Brief, the Petitioners submit that the members of this Court should grant their Joint Petition for Certiorari, and should use this case as a vehicle to further delineate the proper standards to be applied by the IRS in the use of the bank deposits (indirect) method of proof; the proper application of the burden of proof and presumption of correctness standards in tax cases; as well as to reject the "public policy" based argument originally asserted by the IRS for disallowing Petitioner Dodge the statutory right to exclude the HIP insurance proceeds he received from his gross income, in accordance with the clear intent of Congress as expressed in the unambiguous wording of 26 U.S.C. § 104(a)(3).

Respectfully submitted,

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APPENDIX F

PORTION OF THE CHIEF COUNSEL'S MANUAL
(Department of the Treasury, Internal Revenue Service)

Paragraph (35)8(12)3 ***(9-5-89)***

Determination of Service Position

(1) It is incumbent upon all attorneys in this Office to ascertain what published rulings and regulations are involved in cases handled by them and to follow them unless given specific authority to disregard them, and to mention them in all actions on decision concerning such cases.

(2) All attorneys must ascertain not only rulings and regulations but also any issued documents from the National Office establishing the interpretation and litigation position of the Chief Counsel, as well as the administrative position of the Commissioner. Field attorneys and their supervisors are responsible for compliance with these requirements to the extent that the source of the material is available in the Region.

(3) It is important that positions taken in all briefs in the Tax Court, defense or suit letters for District Court and Claims Court cases, actions on decision, etc., correctly reflect Service position, and that they should not be at variance with outstanding regulations, rulings, acquiescences and nonacquiescences. It is also important that the development of regulations and rulings take proper cognizance of court decisions and pending litigation which may affect or be affected by such regulations and rulings. It must be remembered, however, that a ruling, regulation, etc., which applies a principle on the basis of a particular set of facts may or may not represent a position which should be applied broadly, or in a different factual situation, and that the final decision as to the litigation position to be followed in cases not clearly covered by

existing rulings, etc. remains with the National Office. Thus, the National Office may, as a matter of discretion, overrule or revise arguments advanced by the field in situations not clearly covered by existing rulings or interpretations, etc.

(4) Anything signed or approved by or in the name of the Chief Counsel should represent the position of the entire office and not merely the position of a particular division or part of the office.

(5) In cases involving important issues in which the litigation position of the Service has not been fully or clearly decided, the determination of the litigation position should be made after coordination among the various divisions. Coordination is required not only between the National and field offices, but also between the litigation and technical divisions of the National Office. If the field office deems it inadvisable to litigate an issue in accord with the Service position, the field office should submit the case to Assistant Chief Counsel (Tax Litigation) for tax litigation advice.

(6) The position taken in all cases, whether in the field offices or in the National Office, must be in accord with the technical and litigation position of the Chief Counsel. The Service position, as a general rule, is initially determined in the regulations and published rulings, and it is the role of the litigation divisions of the office to support such positions. Moreover, there may be instances in which it is determined not to specifically follow the regulations or published rulings. In this instance such determination may not be made by the Regional Counsel, or delegate, but can only be made by National Office officials.

(7) Attorneys are expected to utilize fully all available research materials. For field attorneys, if after having examined and considered all available research material there is still uncertainty as to the Service position on the issue, the Regional Counsel, or delegate, should request advice from the Assistant Chief Counsel (Tax Litigation).

(8) Except as may be specifically authorized by duly delegated officials, the position taken by the attorney at each stage of the handling and processing of a case must be in accord with the litigation and settlement position of the Chief Counsel. This is applicable to the settlement, trial and other processing of cases by field attorneys, the review of briefs and actions on decision in the National Office, and in any recommendation to the Department of Justice with regard to any case in litigation.